ONTARIO PAPERS ON FEDERAL-PROVINCIAL FISCAL ARRANGEMENTS

Reprinted and Summarized
for the Meeting of
Provincial Ministers of Finance
Victoria, B.C., June 25 and 26, 1981

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Ministry of Treasury and Economics
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Preface

This document has been prepared for the convenience of the participants in the renegotiation of the Federal-Provincial Fiscal Arrangements. It contains three recent Ontario Budget Papers on this important subject. These papers discuss: (i) the negotiation process of five years ago and the details of the agreements reached for the 1977-1982 period; (ii) the facts, concerns and considerations relevant to the current negotiating process; and (iii) the evolving Ontario position on the wide range of issues that need to be addressed in the dialogue leading to agreements for the 1982-1987 period.

It is hoped that this collection of papers will contribute to the on-going discussions and will be of assistance in formulating new fiscal arrangements.

A. Rendall Dick
Deputy Minister

Bernard Jones
Assistant Deputy Minister

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SUMMARY OF ONTARIO'S POSITION ON FEDERAL-PROVINCIAL FISCAL ARRANGEMENTS

Shared-cost arrangements, tax sharing, the federal revenue equalization program, and the Tax Collection Agreements have all undergone substantial revision over the decades. During the early 1970s, Ontario pushed for jurisdictional "disentanglement" and increased provincial flexibility in respect of the major cost-sharing arrangements for hospital insurance, medicare and post-secondary education. The preferred Ontario approach was complete provincial assumption of the responsibility for these programs and the attendant fiscal risk, in exchange for an appropriate transfer of personal income tax points. The Established Programs Financing arrangement (EPF) agreed to in late 1976, after extended federal-provincial negotiation, reflects this approach.

The introduction of block-funding under EPF was widely hailed as a major innovation in Canadian federalism. The origin and structure of EPF were fully discussed in a 1977 Ontario Budget Paper, reproduced here under its original title "Federal-Provincial Fiscal Reforms". This paper remains one of the few published accounts of this vitally important development in Canadian public finance.

The EPF arrangement is currently being discussed prior to an extension for the 1982-1987 period. A 1981 Ontario Budget Paper, "Renegotiation of Federal-Provincial Fiscal Arrangements", examines the first five years of EPF in light of the objectives that were originally set for this program. On the controversial matter of financing, it is shown that federal contributions under the program have grown as originally anticipated by Ottawa in 1976, that provinces face substantial fiscal risks under the program in the upcoming years, and that the federal "share" of provincial expenditures, having risen in the early years because of well understood transitional and cyclical factors, is already on the decline. Overall, the analysis confirms Ontario's view that the program has been a substantial success over the past five years. Ontario therefore believes that the EPF arrangement should be continued without substantial alteration. Major changes at this time, whether federally or provincially inspired, would undermine the crucial 1976 understanding that EPF was to be a long-term arrangement.

Another important program up for renewal in 1982 is the revenue equalization program. Ontario has long supported federal equalization payments to the less wealthy provinces, and continues to do so. However, the credibility of this program has been badly eroded by the rapid growth of natural resource revenues in the oil and gas producing provinces and the consequential measures that the federal government was forced to take to contain its equalization liabilities. The resource-related problems of the equalization program are fully discussed in the 1980 Ontario Budget Paper entitled "Equalization and Fiscal Disparities in Canada". Particular attention is drawn to energy-induced "over-equalization", a phenomenon implied by the fact that the formula has generated over $1.3 billion in "notional" entitlements to Ontario, despite the above-average per capita incomes and public services enjoyed in this province.

Ontario is strongly of the view that the equalization program needs to be comprehensively reformed in the light of the new inter-regional fiscal disparities emerging as a result of oil and gas developments. The 1980 Ontario paper offered several reform scenarios. A key theme of the Ontario approach is that there should be a clearer separation of "basic" equalization (which is intended to allow provinces to provide comparable services at more or less comparable tax burdens) from resource rent recycling (which is currently happening in an unintended and unfair way through the formula). Canada's growing fiscal imbalance among provinces necessitates the study of new sharing mechanisms which may entail direct contributions from the resource rich provinces. The 1981 Ontario Budget reiterated Ontario's concerns with equalization, adding that unless imaginative new approaches to sharing are devised, Ontario will no longer accept its arbitrary exclusion from equalization payments.

The paper reproduced from the 1981 Budget discusses EPF, equalization, and inter-provincial tax harmony, emphasizing the ubiquitous impact of the widening fiscal disparities among provinces. Ontario believes that the large-scale retrenchment in federal transfers to the provinces announced in the October 1980 federal budget is totally unjustified. Transfer payments have not contributed meaningfully to the federal government's budgetary problems. More importantly, federal revenues can be expected to improve dramatically under the National Energy Program, and the burden of any cuts in social transfers would be distributed unfairly among provinces, causing taxes to go up in provinces where tax effort is already high and expenditures to be cut in provinces that have the highest expenditure needs. The analysis demonstrates that federal fiscal retrenchment should be subordinated to the much more important goal of resolving the fiscal disparities among the provinces.

These disparities have risen sharply and hold the potential for unhealthy fiscal and economic competition among the provinces. Overt competition in taxation and subsidies, if carried beyond a certain point,

would be disruptive to the domestic economy and to governmental finances. Ontario endorses the search for new mechanisms to protect the Canadian common market from such disruptive developments.

Ontario attaches a high priority to the renegotiation of the federal-provincial fiscal arrangements, and looks forward to new agreements that comprehensively address the emerging problems of the 1980s.

Renegotiation of Federal-Provincial Fiscal Arrangements: An Ontario Perspective

Budget Paper B

Ontario Budget 1981

Renegotiation of Federal-Provincial Fiscal Arrangements: An Ontario Perspective

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Renegotiation of Federal-Provincial Fiscal Arrangements: An Ontario Perspective

Introduction

Until the early seventies, federal-provincial relations evolved against a background of a fiscally strong federal government and an under-financed provincial sector with rapidly rising responsibilities. This "vertical" fiscal imbalance was corrected from time to time by federal-provincial fiscal agreements transferring more resources to the provinces.[1] By the end of the seventies, however, the federal government was saddled with an excessive budgetary deficit while the provincial sector had moved into a surplus position. This turnaround in fiscal imbalance between the two orders of government has prompted the federal government to put the gears of fiscal arrangements into reverse.

In its October 1980 budget, the federal government set out a plan to reduce its excessive deficit over the next few years. It proposed measures on many fronts to achieve both downward modifications in spending and increased revenue prospects. One of the more controversial aspects was the announcement that savings would be sought from ". . . reductions in federal transfers to provinces relating to areas coming under provincial jurisdiction." The federal government is renegotiating the terms of the Federal-Provincial Fiscal Arrangements and Established Programs Financing Act, as well as the Canada Assistance Plan, with this objective in mind.

This paper disputes the need for reductions in intergovernmental transfers. It argues that federal retrenchment at provincial expense risks aggravating the already serious problem of fiscal and economic imbalance that has emerged among the provinces. This issue of "horizontal" fiscal imbalance should set the tone and direction of the negotiations for the 1982-87 fiscal arrangements period. The paper therefore emphasizes the need to reform the federal equalization program and to implement some form of inter-regional sharing of the unevenly distributed resource revenues. The danger of increased tax competition among provinces is also discussed. The paper concludes that the long-term national interest requires the fiscal viability of both orders of government and fiscal and economic balance among the regions of Canada.

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[1]For a convenient summary, see *The National Finances 1980-81,* Canadian Tax Foundation, Chapter 10 (Toronto 1981).

I Transfer Reductions in Perspective

Between 1970 and 1980, the federal budgetary deficit rose from $1 billion to $14 billion. On a national accounts basis, the federal position moved from virtual balance to a deficit equivalent to 4.2 per cent of Gross National Product. The unprecedented deficits of recent years have occasioned a great deal of concern in the business and academic communities. It is now widely accepted that large deficits contribute to inflation even when resources are less than fully employed, that their financing can lead to a crowding out of private sector investment, and that they can undermine the general level of business and consumer confidence. The most recent federal budgets have recognized these concerns by attaching a high priority to the reduction of the deficit. The Government of Ontario supports this broad objective. For its part, Ontario has had an active policy since 1975 of restoring its capacity to balance the Provincial budget.[2]

The deficit reduction strategy adopted in the federal budget involves substantial cuts in transfers to the provinces. The Minister of Finance, the Honourable Allan MacEachen, has indicated that he is seeking

The Fiscal Negotiations in respect of the 1982-87 period will focus on:

1. *The Federal-Provincial Fiscal Arrangements and Established Programs Financing Act*

   Part I. This Part provides for the fiscal equalization program under which the federal government makes unconditional payments to provinces with below average revenue-raising capacity. In 1981-82 the program is worth over $3.6 billion.

   Part III. This Part provides the authority by which the federal government enters into personal income tax collection agreements with nine of the provinces and corporate income tax collection agreements with seven of the provinces.

   Part VI. This Part provides for federal assistance toward the cost of the "established programs" in health and post-secondary education, as well as a partial settlement in respect of the 1972 Revenue Guarantee. The federal contribution consists of tax room and cash. In 1981-82, the Established Programs Financing arrangement is worth nearly $11 billion. This Part also provides for Extended Health Care payments, worth $715 million in 1981-82.

2. *The Canada Assistance Plan (CAP)*

   Under this program, the federal and provincial governments share the costs of certain income support and social services programs. The 1981-82 federal contribution is $2.3 billion. CAP was included in the terms of reference given to the Parliamentary Task Force on the Fiscal Arrangements.

3. *The Community Services Contribution Program*

   This recently-terminated program provided $250 million per year to the provinces for a broad range of community services, primarily water and sewerage projects.

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[2]For a discussion of Ontario policy, see Hon. W. Darcy McKeough, "Towards a Balanced Budget", Budget Paper C, *Ontario Budget 1977* (Toronto: Ministry of Treasury, Economics and Intergovernmental Affairs, 1977).

savings of $500 million in 1982-83, and of $1 billion per year thereafter. These are net amounts to be applied against the deficit, leaving open the possibility of larger reductions at provincial expense. In this connection, it has been suggested that Ottawa might seek further reductions in its social policy transfers, either to finance adjustments in the revenue equalization program to offset any Established Programs Financing (EPF) cuts borne by the less affluent provinces, or to reallocate funds to other federal programs within the social affairs envelope. This Section of the paper argues that such a large-scale retrenchment in fiscal transfers is both unjustified and unwise.

Growth in Transfers

A review of the 1970s shows that transfers to the provinces have not been a significant cause of the federal government's fiscal difficulties. Table 1 presents data on federal budgetary spending, intergovernmental transfers and the deficit. Between 1972-73 and 1976-77, the growth of total budgetary spending exceeded the growth of intergovernmental transfers in every year but one, when a large increase in Revenue

Federal Finances and Provincial Transfers, 1972-73 to 1983-84 — Table 1
($ million)

Fiscal Year	Federal Budgetary Spending	Change	Federal Transfers to Provinces	Change	Federal Budgetary Deficit
		(%)		(%)	
1972-73	16,121	8.6	4,413	5.4	1,000
1973-74	20,039	24.3	5,059	14.6	1,384
1974-75	26,055	30.0	6,453*	27.6	1,733
1975-76	33,181	27.3	7,383	14.4	5,463
1976-77	38,930	17.3	9,062**	22.7	6,210
Growth during the period		162.3		116.5	
1977-78	42,882	—	9,352**	—	10,289
1978-79	46,922	9.4	10,484	12.1	12,226
1979-80	52,364	11.6	11,658*	11.2	11,375
1980-81	59,350	13.3	12,775	9.5	14,150
1981-82	66,640	12.3	14,150	10.7	13,705
Growth during the period		55.4		51.3	
1982-83	73,725	10.6	14,925	5.5	12,125
1983-84	81,215	10.2	15,900	6.5	11,795

Sources: Statistics Canada, Catalogue 68-211.
Government of Canada Budget, October 28, 1980.
*Incorporates extraordinary increase in equalization payments.
**Major cash flow for the 1972-76 Revenue Guarantee.

Guarantee payments occurred.[3] The greatest leap in the deficit occurred in 1975-76, when it suddenly jumped from $1.7 billion to nearly $5.5 billion. In that year, budgetary spending rose by almost 30 per cent, while transfers to the provinces rose by only 14 per cent.

Similar observations can be made for the 1977-78 to 1981-82 period, although comparisons between the two halves of the decade are complicated because of the restructuring of transfers in 1977. Transfer growth exceeded spending growth in 1978-79, but the average rate of growth over the five-year period is expected to be less than the corresponding average for spending. A large increase in the deficit occurred in 1980-81, but in that year the growth in transfers was considerably below that in budgetary spending.

These facts suggest that the deterioration in the federal government's financial position cannot be explained by changes in intergovernmental transfers. The federal circumstances are due to the same pressures facing the majority of the provinces. Revenue growth has fallen off as a result of a lack of growth in the economy and structural alterations to the tax system, including the indexation of the personal income tax. At the same time, rising inflation and high levels of unemployment have levered up social spending and public debt interest charges. Also, the federal government has had to absorb the net costs of the Oil Import Compensation Program.

Intergovernmental transfers are, of course, a large component of the federal budget, amounting to over one-fifth of spending. Accordingly, transfers cannot be entirely exempted from any effort to reorganize spending priorities. On the other hand, federal transfers represent an even larger share of provincial revenues, particularly in the less wealthy regions.[4] This makes it imperative that federal objectives be pursued with due regard to the problems and priorities of other levels of government.

Restraint has been a federal objective for a number of years. It is interesting to note the change in tone and emphasis between the current restraint exercise and the one initiated in the summer of 1978. As the Prime Minister explained in his October 2, 1978 letter to Premier Davis:

> "... it became apparent that our expenditure reduction commitments could not be met without some contributions from (intergovernmental transfer) programs. We believe that we have been fair in our approach to this problem with *the reductions in transfers to provinces being proportionately less severe than those being applied to programming which is our direct responsibility*". (emphasis added)

The cuts proposed in 1978, though not welcome, were a more realistic approach to the fiscal situation confronting the federal government

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[3]The Revenue Guarantee is discussed on page 14 of this paper.

[4]In 1980-81, federal transfers to the provinces ranged from 9 per cent to 54 per cent of provincial budgetary revenue.

and the provinces. The much larger cuts implied by the transfer projections for 1982-83 and 1983-84 mean that provinces will be called upon to bear an unfair and unrealistic share of future restraint.

Federal Revenue Prospects

The expected improvement in federal revenues is another reason why major transfer reductions are unjustified. The overall GNP elasticity of the federal revenue structure can be expected to increase significantly in future years as Ottawa's share of oil and gas revenues increases, and as the incomes generated by this sector continue to outpace the growth of the economy in general. By contrast, the revenue prospects of the energy-consuming provinces are not so bullish. In short, the federal government has already set in motion a correction of the vertical imbalance that began to emerge in the 1970s. The more optimistic outlook for the long term means that Ottawa has the capacity to avoid precipitous cuts in transfers.

The Inequitable Impact of Cuts

The proposed transfer reductions must also be examined in light of the horizontal fiscal imbalance that has emerged between the oil and gas producing provinces and the consuming provinces. Table 2 displays the surpluses and deficits for the various provinces over the past decade, on the basis of the Statistics Canada financial management data series.[5] The surplus positions of the Western provinces will grow spectacularly during the 1980s, even with the federal government taking a larger slice of oil and gas revenues under the National Energy Program. Federal transfers, however, are largely concentrated in Eastern and Central Canada by virtue of the distribution of population and conventional tax bases. This means that the bulk of any transfer reductions must almost certainly be borne by the provinces with the least fiscal capacity.

Provinces currently receiving equalization payments could, as part of a federal strategy, be protected against cuts in EPF by way of offsetting increases in equalization. However, this approach would isolate Ontario as the only province whose fiscal position is undermined by federal transfer cuts. Such an inequitable result would only add to the fact that, between 1977-78 and 1981-82, Ontario will have been denied over $1.3 billion in equalization entitlements while its economy was

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[5]For reasons of comparability among the provinces, Statistics Canada adjusts the data obtained from the public accounts of the provinces. As a result, these data tend to vary considerably from data shown in provincial budgets. Major adjustments in revenue and expenditure are involved, notably in respect of capital expenditure for some provinces, and special funds, corporations and boards, such as superannuation, financing authorities, and workmen's compensation boards.

Provincial Government Deficits and Surpluses, Selected Fiscal Years

Table 2

($ million)

	1972-73	1976-77	1977-78	1978-79	Cumulative 1972-73 to 1978-79
Newfoundland	−58.1	−139.4	−49.4	−222.3	−791.8
Prince Edward Island	1.8	−0.3	−22.3	−10.2	−46.3
Nova Scotia	−9.6	−28.3	−108.4	−160.8	−378.6
New Brunswick	−22.8	−86.2	−96.2	−36.0	−362.4
Quebec	−267.3	−908.2	−740.8	−1,160.3	−4,315.9
Ontario	−344.4	−1,025.5	−1,464.6	−1,211.6	−6,537.3
Manitoba	33.5	−58.6	−259.5	−63.7	−456.7
Saskatchewan	31.6	51.5	4.3	130.2	624.5
Alberta	−24.3	942.5	1,928.2	2,836.2	7,505.2
British Columbia	127.5	161.2	233.2	204.1	521.9
All Provinces	−532.1	−1,091.3	−575.5	305.6	−4.237.4

Source: Statistics Canada, Catalogue 68-207.

called upon to finance oil-generated increases in equalization payments to the traditional recipient provinces.[6]

If transfer cuts are made without regard to the different fiscal situations of the provinces, an already problematic condition will be aggravated. The off-loading of federal problems onto provincial governments will cause taxes to go up in provinces where tax effort is already high and expenditures to be cut in provinces that tend to have the highest expenditure needs. Chart 1 presents one measure of tax effort for the provinces. Although tax effort can be measured in many different ways, the evidence indicates that a substantial difference in tax effort exists between the oil-rich provinces and all the others.[7] It is far more difficult to measure expenditure need, but few would argue that provincial spending on social and economic development ought to be cut in the non-producing provinces relative to the producing provinces.

The growing fiscal imbalance among provinces makes it unrealistic for the federal government to use across-the-board transfer cuts as a mechanism of restraint. Major programs like EPF or the Canada Assistance Plan (CAP) should not be scaled down without compensatory adjustments elsewhere in the fiscal arrangements. But

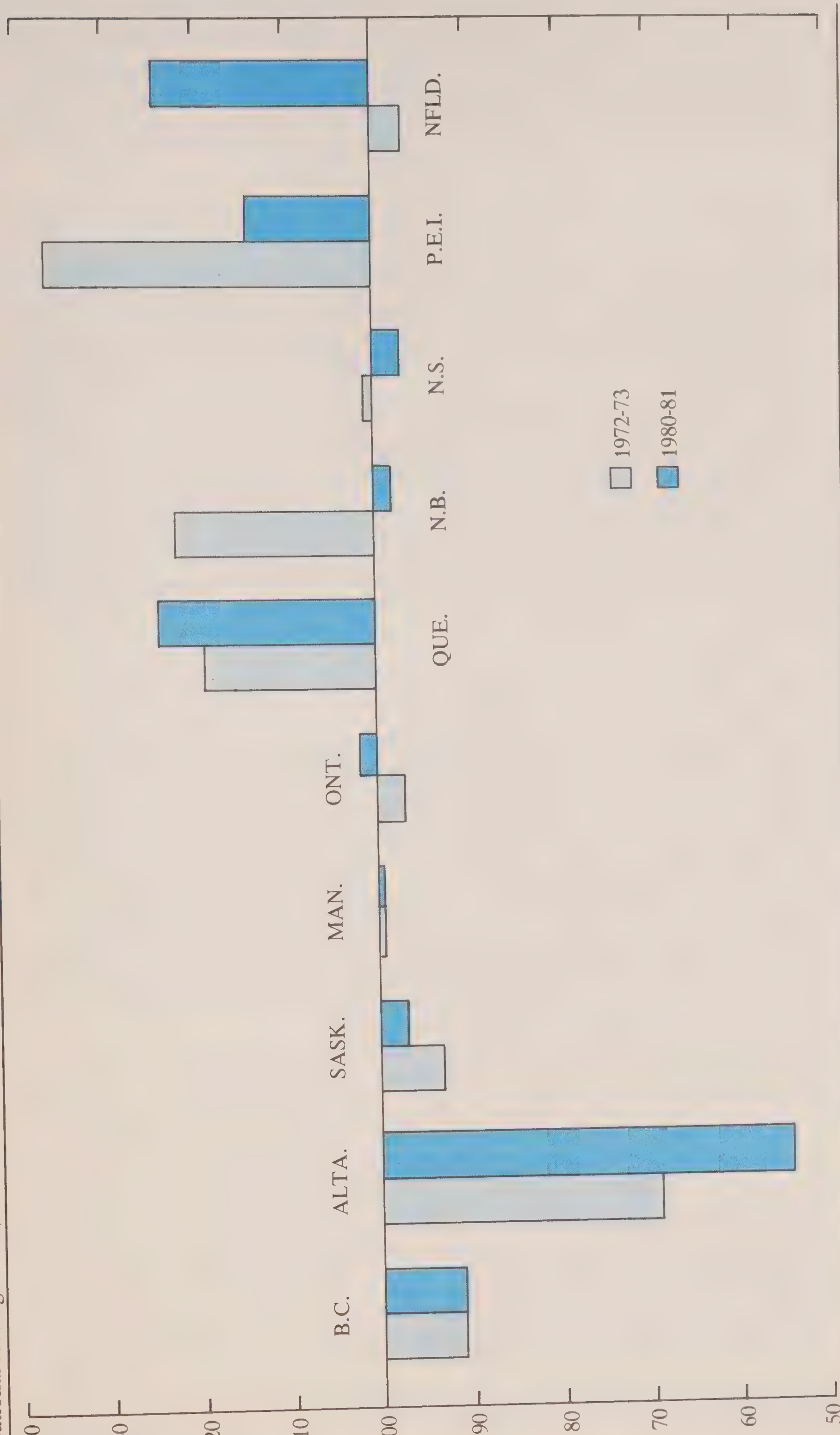
[6]Bill C-24 (the 1981 retroactive amendment imposing a per capita income override on equalization) has excluded Ontario from the following entitlements:

1977-78	$ 113 million
1978-79	$ 296 million
1979-80	$ 464 million
1980-81	$ 265 million
1981-82	$ 209 million
Total	$1,347 million

[7]For a discussion of tax effort see the Appendix.

Chart 1

Indices of Relative Tax Effort, 1972 and 1980
(National Average = 100)



Note: Derived from present equalization system, and expressed as the share of total revenue relative to the share of comprehensive tax base, but excluding all natural resources.

such adjustments must ensure that all non-oil and gas producing provinces are treated fairly, not just the traditional equalization recipients. To recognize this is to subordinate federal fiscal retrenchment to the much more important goal of resolving the inter-regional fiscal imbalance.

The EPF Arrangement

It needs to be stressed, as well, that the Established Programs Financing arrangement is not "over delivering". As part of its strategy to achieve "significant savings" in transfers, the federal government has created the impression that EPF has been much more generous than originally anticipated, and that provinces have made unwarranted gains.[8] This issue is fully examined in Section II of this paper. The conclusion is that EPF has not in fact gone astray when proper attention is accorded to its original objectives, the long-term nature of the agreement, and the spending pressures that are now building up. The success of the 1981 negotiations will depend in large measure on the willingness of governments to appraise EPF dispassionately in terms of the objectives that were set for it.

The Lack of Consultation

Finally, it is of considerable importance to examine the way in which transfer restraint is being handled by the federal government. Because of the need for long-term planning in the design and delivery of the major joint programs, it is critical that there be a full and careful review of all proposed changes. The October budget contained the threat of significant cuts, but gave no details. Two weeks later, the Community Services Contribution Program, worth $250 million to the provinces, was abruptly terminated. It has never been made clear whether this reduction is included in the total savings that the federal government is seeking from the provinces.

The federal Minister of Finance announced on February 5 that a Parliamentary Task Force would be set up to examine the fiscal arrangements within the context of the government's expenditure plan as set out in the October 28 budget, with a mandate to report by the end of June. It was later indicated that the federal government would not have specific proposals to make until such time as it had reviewed the work of the Task Force. This means that some eight to ten months will have elapsed between the announcement of transfer cuts and the tabling of negotiable proposals. Provincial budgeting has, in the meantime, been forced to proceed under considerable uncertainty.

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[8]See, for instance, Hon. Monique Begin, "Notes for a Statement to the Press", Toronto, May 14, 1979.

In summation, a program of large-scale reduction in federal transfers to the provinces is highly inappropriate given current fiscal circumstances, and could potentially aggravate interprovincial disparities. Moreover, it could undo important past accomplishments in rationalizing the major programs in health and post-secondary education.

II The Success of EPF

The adoption of the Established Programs Financing arrangement in 1977 was an historic achievement. EPF culminated many years of federal-provincial negotiations, and incorporated features from innumerable proposals and counter-proposals. More importantly, it embodied a new approach to intergovernmental fiscal arrangements. The origin and structure of EPF were described in the 1977 Ontario Budget.[9] This Section of the paper will briefly review the experience under EPF from the point of view of the program's objectives.

The broad outlines of EPF were put forward at a Conference of First Ministers held in June 1976. At that time, the Prime Minister indicated the five principles that would form the basis of the federal approach[10]:

- The federal government should continue to pay a substantial share of program costs.
- The federal payment should be calculated independently of provincial program expenditures.
- There should be greater equality, in per capita terms, in the federal contributions to the provinces.
- The arrangements for the mature programs should be placed on a more permanent footing.
- There should be provision for continuing federal participation in the development of policies of "national significance" in health and post-secondary education.

There was widespread provincial acceptance of most of these principles, and a federal-provincial consensus on the course that was being charted.

A Financial Assessment

With regard to the first principle, the federal government has continued to pay its fair share of the costs of the established programs. But in the context of the severe restraint that is currently being

[9]See Hon. W. Darcy McKeough, "Federal-Provincial Fiscal Reforms", Budget Paper B, *Ontario Budget 1977* (Toronto: Ministry of Treasury, Economics and Intergovernmental Affairs, 1977).

[10]Statement tabled by the Prime Minister of Canada, the Right Honourable Pierre Elliott Trudeau, on the occasion of the Conference of Federal and Provincial First Ministers, held at Ottawa, June 14 and 15, 1976.

proposed by the federal government, the real question is whether there is any ground for believing that Ottawa has paid more than its fair share. Ontario is not persuaded that it has. This conclusion can be supported in several ways.

One approach is to compare what the federal government expected to contribute just before the EPF formula was adopted with what it has actually contributed over the last few years. Table 3 presents this comparative data. It can be seen that the current level of EPF tax and cash transfers is reasonably within the range forecast in 1976. This demonstrates clearly that federal contributions have not become unexpectedly generous.

Table 3

Comparison of 1976 Federal Projections of EPF Entitlements With Actual EPF Entitlements

($ million)

Fiscal Year	Projected Total EPF Entitlements*		Actual Total EPF Entitlements**
	"High Price"	"Standard Price"	
1977-78	6,151	6,122	6,186
1978-79	7,032	6,931	7,092
1979-80	8,062	7,848	8,052
1980-81	9,175	8,770	8,931
1981-82	10,384	9,772	9,947

Source: Department of Finance.

*The "high price" projection assumed higher inflation and growth in real incomes than the "standard price" projection.

**Only 1977-78 has been finalized. Revenue Guarantee settlement has been removed.

The components of EPF have however behaved in unexpected fashion. The yield of the transferred tax points has been lower than expected, with the result that large transitional adjustment payments have become necessary to ensure that the value of the total package is equal to the all-cash guarantee. But it cannot be inferred from the growth in the cash contributions that EPF is "over delivering". The growth the provinces receive is generated by the tax plus cash total, not the cash component alone. It is the former that has to be used in evaluating the financial experience under EPF.

A second argument is that EPF is, by its very nature, a long-term arrangement. This is implicit in the fourth principle. It is therefore inappropriate to attach a great deal of significance to the movement of the federal and provincial "shares" over the short run. The total federal contribution measured against Ontario spending on the established programs and related functions did indeed rise during the first years. This happened for two main reasons. The Province was successful in reducing its expenditure growth rate in these areas, and the federal contributions were propelled upward by the higher inflation

The Structure of EPF

1. The EPF package established in 1977-78 consists of both tax room and cash transfers from the federal government to the provinces.
2. The package is based on the federal government's national average per capita contribution in 1975-76 under the established programs (hospital insurance, medicare and post-secondary education).
3. A province's "basic cash" entitlement for each year is equal to 50 per cent of this base-year federal contribution per capita, escalated over time by a cumulative growth index, and multiplied by the population of the province.
4. The escalator for each year is the compound average rate of growth of nominal GNE per capita over the three preceding years.
5. The tax room amounts to 12.5 equalized personal income tax points and 1 equalized corporation income tax point.
6. A transitional cash adjustment payment is made, if necessary, to bring the value of the tax points up to the value of the "basic cash".
7. Since the base-year federal contribution per capita varied among provinces, levelling adjustments were employed to ensure that all provinces received equal per capita contributions by 1981-82.
8. An additional equalized personal income tax point and its associated cash value are provided as partial compensation for the Revenue Guarantee which terminated at the end of 1976.

of earlier years that is built into the lagged GNE escalator.[11] These circumstances no longer hold. Ontario now anticipates considerable spending pressures in these program areas as a result of rising inflation. At the same time, the lag in the escalator will cause EPF transfers to grow more slowly than current spending. In fact, preliminary estimates suggest that the federal "share" is already beginning to decline. The movement of the federal and provincial "shares" is clearly a cyclical phenomenon, and is of no particular importance in the context of an arrangement that was well understood to be long term in nature.

In any event, a rising federal share was fully planned and expected in the short term. In the case of those provinces with below average per capita transfers in 1975-76, EPF involved a three-year upward levelling of federal per capita contributions and thus a degree of front-end loading that quickly increased the federal share. Much more important, however, was the intended deceleration of provincial spending. A key goal in adopting EPF was to give the provinces the flexibility and incentive they needed to reduce the growth of program expenditures in

[11]The relationship between current GNE growth and the EPF escalator, both on a per capita basis, is displayed below:

	Current GNE Increase	EPF Escalator
1976-77	14.04	14.70
1977-78	8.06	14.01
1978-79	8.98	10.82
1979-80	12.39	10.32
1980-81	9.56	9.80
1981-82	12.92 (est.)	10.30

the health and post-secondary education areas. As the Prime Minister said:

> "(The EPF proposal) also suits the current and future imperative, namely fiscal restraint, in that Provinces will have a greater incentive to implement what are admittedly difficult measures designed to restrain spending in these fields to reasonable levels."[12]

The incentive to provincial restraint provided by EPF was accompanied by the termination of the Revenue Guarantee, a step which seriously weakened provincial finances. The delivery systems are now much leaner and more efficient than they were in 1976. The provinces bear 100 per cent of the future risks under EPF. Their burden should not be aggravated by a "penalty" for having done successfully what the federal government clearly encouraged them to do when the agreement was struck less than five years ago.

Another point that cannot be overlooked in any financial assessment of EPF is the continued deterioration of provincial income tax revenues occasioned by the 1972 income tax reforms. The Revenue Guarantee that was put in place to protect provinces ballooned from a projected five-year cost of $50 million to a staggering five-year actual cost of $2.6 billion, even allowing for the arbitrary change of the formula that was made in 1976 to shave an estimated $750 million from provincial entitlements. The Revenue Guarantee payments were critical to provincial finances and the negotiation of an extension of the program was a key aspect of the 1976 discussions. In the end, approximately two personal income tax points were added to the EPF tax and cash settlement. This compromise, which represented about 40 per cent of what the Guarantee was worth in 1976, remains critical to provincial finances. The continuing losses that the provinces have sustained as a result of the compromise far exceed any "surplus" contributions that the federal government might think it has made through EPF.

Block Funding

Turning to the second principle of EPF — the independent calculation of federal payments — it can be said that the introduction of block funding was a major innovation in Canadian federalism. The old principle of cost sharing was abandoned, and federal payments were set to grow each year by an average measure of growth in the economy.[13]

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[12]The Right Honourable Pierre Elliott Trudeau, Statement to Conference of First Ministers, December 13, 1976.

[13]The pre-EPF arrangements were not precisely dollar-for-dollar matching because of the national average per capita cost feature in the health-sharing formulas and the escalated $15 per capita option in respect of post-secondary education. These features gave rise to federal shares that varied above and below 50 per cent of provincial spending on eligible costs. A share above 50 per cent was said to include "implicit equalization". For a discussion, see Hon. Charles S. MacNaughton, "The Structure of Public Finance in Ontario", Budget Paper B, *Ontario Budget 1970* (Toronto: Ontario Department of Treasury and Economics, 1970).

The federal government thereby achieved greater predictability in its payments, and the provinces achieved the flexibility to manage their programs in a manner more appropriate to their individual priorities. Specifically, the reform eliminated the major disincentives to cost control that were inherent in the structure of the old cost-sharing arrangements.[14] As well, the administrative costs of both orders of government were reduced.

Despite the mutual advantages of block funding, the past five years have witnessed a certain amount of federal back-sliding on this important principle. For its own internal reasons, the federal government chose to divide its cash payments among the three programs on the arbitrary basis of the share of federal contributions going to each program in the 1975-76 base year. These ratios then came to have a life of their own. Attempts were made to prove that provinces had "diverted" federal dollars intended for health care by using these ratios to re-establish implicitly a matching relationship between federal contributions and provincial spending.[15] This component-by-component approach to evaluating EPF is a denial of its essential character as a block funding arrangement. Ontario continues to support strongly the principle of block funding.

Equal Per Capita Contributions

The third federal objective was the attainment of equal per capita contributions to the provinces. This has now been accomplished through the upward and downward levelling adjustments that were part of the transition to the "mature" EPF arrangement. Ontario initially had reservations about the expansion of "implicit" equalization inherent in the increased per capita transfers to the lower spending provinces.[16] The wisdom of upward levelling now has to be considered in light of the over-equalization that has occurred under the revenue equalization program. However, given the general acceptability and simplicity of equal per capita contributions, this principle should be preserved as part of EPF.

In view of the possibility of substantial fiscal dividends from the tax part of the package accruing in larger measure to the wealthy provinces, it may be necessary to strengthen the equal per capita principle through the introduction of a mechanism by which the

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[14]Prior to 1977, the federal government cost shared in respect of about 80 per cent of the health care field. High cost hospital services were shareable, but many low-cost alternatives to hospitalization were not. The result was that provinces sometimes found it effectively cheaper to spend on the high-cost services rather than rationalize their delivery systems.

[15]The Hall Commission Report of 1980 exonerated the provinces from any dollar diversion. For a complete discussion, see Hon. Emmett M. Hall, CC., Q.C., *Canada's National-Provincial Health Program for the 1980's*, August 1980.

[16]See footnote 13.

federal government could recapture any per capita "surplus" that might accrue to a province.

Long-Term Certainty

From Ontario's point of view, the fourth federal principle was perhaps the most important. The mature programs were to be "established on a more or less permanent footing", precisely because the record of federal ceilings and audit rulings had thrown into question the long-term federal commitment to these programs. The Prime Minister made this point most persuasively in his statement to the First Ministers' Conference of June 1976, and then went on to add that:

> ". . . notice (of termination) would not be given lightly, because the intention is to underline the relative permanence and stability of the new arrangements."[17]

Over recent months, concern has grown that, despite this commitment to permanence and stability, the federal government is contemplating major structural changes to EPF. Specifically, there are concerns that the post-secondary education component of EPF could be removed from the program, with part of the federal savings channeled into direct assistance to students and enlarged grants to institutions for research and development. Such a move could lead to substantial complications for provinces, including major changes in the way that students and institutions are currently funded. It would mark a retreat from a barely-tested program that only four years ago was being hailed as a milestone on the road to federal-provincial disentanglement and cooperation. Certainly, the federation does not need another situation like the Community Services Contribution Program – a major federal-provincial program that was arbitrarily terminated by the federal government within two years of its inception, notwithstanding a formal commitment in the agreements to negotiate a continuing program that would provide "long-term certainty" to the provinces.

National Standards and Federal Visibility

In respect of the fifth objective, there are reasonable grounds for the federal government to believe that EPF has not worked as well as intended. That objective was "the provision for continuing federal participation in the development of policies of 'national significance' in health and post-secondary education". Provinces collectively may have to re-examine the issue of establishing procedures for the federal-provincial discussion of "national" priorities in post-secondary education. Given the federal concern over the preservation of national

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[17]The Right Honourable Pierre Elliott Trudeau, Statement, June 14 and 15, 1976, *op. cit.*

standards in the health area, it could be useful for the federal government and the provinces to discuss criteria for ensuring that national standards are maintained. Finally, governments could examine ways of making Canadians more aware of the federal government's financial contribution toward the established programs. The onus, however, remains on the federal government to set forth its requirements in as specific a manner as possible.

Briefly summarizing, the Established Programs Financing arrangement has been a substantial success. Such problems as may be conceded to exist could undoubtedly be resolved without major alterations.

III Equalization and Fiscal Disparities

During the past five years, the equalization program has come to occupy a strategic place in the intergovernmental discussions on energy pricing, horizontal fiscal imbalance, and the overall federal-provincial transfer system. The 1980 Ontario Budget examined the purposes and structure of the equalization program and analyzed a number of the problems that have arisen recently.[18] These problems are briefly reviewed below.

Problems of the Equalization Program

The difficulties that have emerged in the equalization program are almost entirely the result of the rapid escalation of oil and gas revenues accruing to the producing provinces. The most obvious problem was that oil and gas revenues threatened to markedly increase federal equalization liabilities. The unusual leverage these revenues exert in the formula derives from the very uneven distribution of the tax bases and the fact that the majority of the Canadian population lives in the non-oil and gas producing regions. To preclude excessive payments, a variety of special features had to be introduced in respect of natural resources, including the discount on revenues from non-renewable resources, the one-third ceiling on resource-generated equalization, the removal of Crown lease sales revenue from equalization and, ultimately, the per capita income override. These features have brought the cost of the program under control, but have left its philosophy in disarray.

A second problem arose when the equalization formula unexpectedly generated entitlements to Ontario. Over the five-year period 1977-78 to 1981-82, these entitlements will amount to over $1.3 billion. In response, the federal government introduced legislative measures to prevent payments to Ontario. For its part, the Government

[18]See Hon. Frank S. Miller, "Equalization and Fiscal Disparities in Canada", Budget Paper A, *Ontario Budget 1980* (Toronto: Ministry of Treasury and Economics, 1980).

of Ontario chose not to press for its "notional" equalization, recognizing that its entitlements reflected a problem with the formula, not an inability — as the program objectives state — "to provide comparable levels of public services at tax rates that are not unduly high." It was nevertheless made clear that Ontario's acceptance of the special override on its entitlements was conditional on the program being reformed in 1982 as part of an overall solution to Canada's problem of regional fiscal imbalance.

The 1980 Ontario Budget also drew attention to the problem of over-equalization. Over-equalization has occurred in the sense that, during the 1970s, the equalization entitlements of the recipient provinces grew more rapidly than the cost of providing basic provincial services without unduly high tax burdens. While entitlements were automatically enlarged because of the growth of oil and gas royalties in the West, expenditures were not likewise affected. From a technical point of view, it can be argued that this result came about because the 50 per cent weight on non-renewable natural resources was too high. Alternatively, it can be argued that the "national average" was too high a standard to aim for, given that the national average fiscal capacity is so greatly influenced by the oil and gas producing provinces.

The above problems, taken together, were seen to involve a funding inequity. On the one hand, the Province of Ontario was excluded from receiving equalization. On the other hand, by virtue of the structure of federal taxation, the Ontario economy was being called upon to finance increased equalization to the traditional recipient provinces caused by increased oil and gas revenues in the producing provinces. In other words, through the equalization program, a measure of energy revenue recycling was taking place, but it was being done inadvertently and unfairly. Ontario suggested, as a possible solution, that consideration be given to either an interprovincial resources fund financed by resource-rich provinces that would operate in tandem with a reformed program of basic equalization, or a system of "negative equalization" which would likewise involve contributions from the wealthy provinces. Both these approaches situate the problem squarely within the context of the excessive and widening fiscal disparity between the "top" province and the national average.

The Future of Equalization

Ontario is greatly concerned about the future of the equalization program. The Province cannot accept protecting the funding level of a program that is in such need of reform at the same time that a more soundly based program like EPF is singled out for restraint. Nor can Ontario accept its continued exclusion from equalization entitlements through the use of special case principles. In this respect, the implementation of an Ontario standard would be no less discriminatory

than the current per capita income override. A reduction in the natural resource weight, effectively freezing out Ontario, would also be unacceptable, unless steps are taken to address the larger problem of East-West fiscal imbalance. If imaginative new approaches to interprovincial sharing cannot be devised, Ontario will expect to receive the equalization that it has so far been willing to forego. The latter course might have to entail federal financing through a larger share of oil and gas revenues, or the withholding of various federal transfers to the producing provinces.

The inter-regional disparities that underlie the fiscal arrangements have been the subject of much attention lately. Chart 2 shows the shifts of relative tax capacity over the course of the 1970s. As can be seen, Alberta's fiscal capacity has grown spectacularly. This rapid shift in relative wealth can be expected to continue through the 1982-87 period of the next fiscal arrangements, even with the pricing and revenue-sharing regime of the National Energy Program working to moderate the rate of change. This occurs because energy revenues initially accruing to the provinces and the producing companies are now rapidly working their way through the economy. The increase in the Western provinces' share of the conventional tax bases shows this to be the case.

IV Tax Competition

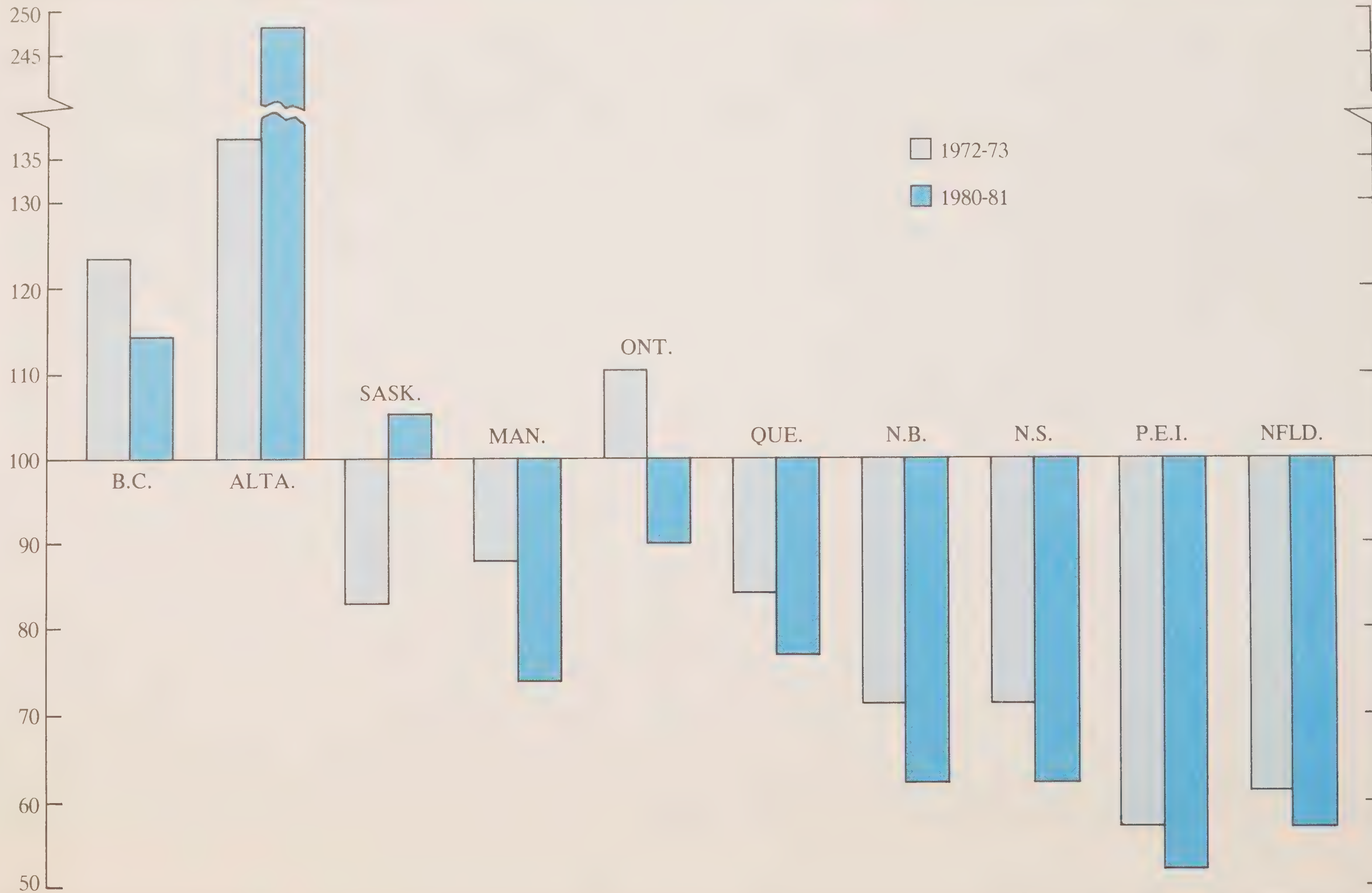
The interprovincial fiscal disparities evolving as a result of the oil and gas situation are leading to a new era of potentially serious economic competition among the provinces. This raises three fundamental concerns: (i) the potential negative impact on government revenues of competitive tax cuts; (ii) the implications of such actions for the distribution of the tax burden; and, (iii) the growing use of direct spending subsidies to industries as an alternative mechanism to influence businesses in their location decisions.

Table 4 shows the range of existing differentials in major tax rates in the ten provinces. These differentials have widened over the past few years. The impact of such differentials on industry and job location is stronger when competing jurisdictions are geographically close. For instance, the considerable tax differentials among the Western provinces are expected to widen further in the years ahead and this is causing concern in that region.

It is important to note that non-tax financial incentives are also employed by the provinces to attract and retain industry. As well, federal regional development policies, including DREE and regionally differentiated investment tax credits, explicitly pursue the national goal of regional economic balance.

Chart 2

Indices of Tax Base Per Capita
(National Average = 100)



Note: Comprehensive tax base, as reflected in present equalization system, but with natural resource revenues at 100 per cent.

Differentials in Major Provincial Tax Rates, 1972 and 1980 — Table 4
(per cent)

	1972	1980
Personal Income Tax	29.6 to 42.5	38.5 to 58.0
Corporations Income Tax	10 to 13	10 to 15
Retail Sales Tax	0 to 8	0 to 11
Gasoline Tax	15¢ to 25¢ per gallon	0 to 29

It is clearly in the interest of the national economy for Canada to have an internationally competitive federal-provincial taxation and investment climate— one that promotes the natural advantages of the various regions. It is equally apparent that overt competition in taxation and subsidies among the regions of Canada, if carried beyond a certain point, would be disruptive to the domestic economy and government finances. However, it is an open question as to what degree of differential in taxation and subsidies would constitute a disruptive situation. All provinces have legitimate aspirations for the development of their economies to full potential.

Within this broader context, the question of tax harmonization and competition is being addressed as part of the fiscal negotiations. Innovative ideas are being examined, including a "Code of Tax Conduct" and the restructuring of the federal corporate tax abatement to ensure that there is at least a minimum level of "provincial" taxation.

Ontario supports this review. The minimizing of undue and uncoordinated interprovincial competition for industry is as important to the maintenance of the common market as the elimination of explicit barriers to trade and the removal of overtly discriminatory aspects of the regulatory and spending practices of governments.

Conclusion

The fiscal arrangements are the third part of the triad that begins with the Constitution and energy pricing. Ontario therefore attaches a high priority to the current negotiations. The Province's goals are to ensure that:

- the problem of regional fiscal and economic imbalance is meaningfully addressed;
- the Canadian common market is protected;
- provinces do not suffer unjustified decreases in intergovernmental transfers;
- the Established Programs Financing arrangement is not substantively altered; and,

- Ontario is not treated unfairly in the context of equalization and inter-regional sharing.

Ontario is confident that the federal government will be able to bring its budgetary deficit under control without transfer reductions beyond the already terminated Community Services Contribution Program. Ontario's major concern is with the excessive fiscal and economic disparities that have arisen as a result of oil and gas revenues. As shown in this paper, these disparities affect the design of the fiscal arrangements in complex ways, and make it necessary to search for "global" solutions that tie intergovernmental transfers to the wellhead price of oil and the division of energy-related revenues. Within the framework of the goals listed above, Ontario is prepared to discuss such comprehensive changes as may be necessary to restore the climate of certainty and national economic leadership that is so greatly needed at the present time.

Appendix

Fiscal Capacity and Tax Effort, 1972-73 to 1980-81

The paper makes extensive reference to the issue of growing fiscal imbalance among the provinces. It also points out that this problem emerged essentially with the rapid increases in the price of oil and gas as these resources are very unevenly distributed in Canada. In this respect, the imbalance can be expected to become even more extreme during the eighties.

In this Appendix, further comparative data are presented in respect of the distribution of tax bases among the provinces and the variations in tax effort. Both measures are examined and displayed in a number of ways, as there are no definitive standard procedures for either.

The measures reflect the influence of energy developments, the shifts in economic activity and their effect on conventional tax bases, and the impact of inter-regional migration. In spite of the differences between the measures examined, there is generally a remarkable similarity in the evidence of widening disparities in fiscal capacities and tax efforts.

Fiscal Capacity

Comparisons have been developed for fiscal capacity in the various provinces, using three different measures, for the years 1972-73, 1976-77, and 1980-81. These are: (1) Provincial Gross Domestic Product as a broad but crude macro indicator; (2) a weighted comprehensive tax base derived from the representative tax system of the equalization program but without a discount on non-renewable resource revenues; and, (3) a weighted comprehensive tax base derived from the representative tax system of the equalization program, *excluding* all natural resource revenues[1]. The results of these comparisons are shown in Table A1.

In order to allow for population shifts, Table A2 displays the same information on a per capita basis and relates the results to the national average. It can be seen that, in the case of both the GDP and the non-resource measures, Atlantic Canada and Quebec maintained a rather

[1]At the end of this Appendix, a technical note describes the methodology used in deriving these weighted comprehensive tax bases.

Shares of Comprehensive Tax Base, Selected Fiscal Years — Table A1

(per cent)

Measure of Tax Base	Nfld.	P.E.I.	N.S.	N.B.	Que.	Ont.	Man.	Sask.	Alta.	B.C.
Gross Domestic Product										
1972-73	1.32	0.28	2.56	1.95	23.90	41.92	4.20	3.60	9.04	11.22
1976-77	1.38	0.29	2.47	1.98	23.61	38.69	4.12	4.30	11.41	11.75
1980-81	1.32	0.29	2.46	1.95	23.59	37.77	3.98	4.30	12.56	11.78
Representative Tax System										
All natural resource revenues at 100 per cent										
1972-73	1.49	0.30	2.61	2.08	23.40	39.52	4.02	3.49	10.44	12.63
1976-77	1.47	0.28	2.34	1.96	21.92	34.87	3.69	4.17	17.24	12.07
1980-81	1.39	0.27	2.23	1.84	20.23	32.41	3.17	4.26	21.64	12.58
All natural resource revenues excluded										
1972-73	1.47	0.32	2.74	2.14	24.20	41.31	4.17	3.38	8.38	11.88
1976-77	1.52	0.32	2.61	2.16	24.29	38.76	4.06	3.87	10.34	12.01
1980-81	1.48	0.32	2.62	2.10	23.61	38.05	3.68	3.76	11.85	12.53

Sources: Ontario Treasury.
Federal Department of Finance.

Table A2

Indices of Tax Base Per Capita, Selected Fiscal Years
(National Average = 100)

Measure of Tax Base	Nfld.	P.E.I.	N.S.	N.B.	Que.	Ont.	Man.	Sask.	Alta.	B.C.
Gross Domestic Product										
1972-73	54	55	70	66	86	117	92	86	119	109
1976-77	57	57	68	67	87	107	92	107	142	109
1980-81	54	56	69	66	89	105	92	106	144	107
Representative Tax System										
All natural resource revenues at 100 per cent										
1972-73	61	57	71	71	84	110	88	83	137	123
1976-77	60	55	65	66	81	97	83	104	215	112
1980-81	57	52	62	62	77	90	74	105	248	114
All natural resource revenues excluded										
1972-73	60	62	75	73	87	115	92	80	110	115
1976-77	62	62	72	73	89	108	91	96	129	112
1980-81	61	62	73	71	89	106	85	92	136	113

Sources: Ontario Treasury.
Federal Department of Finance.

stable deficiency in per capita fiscal capacity relative to the national average. With resources included, they all lost ground because of the overwhelming influence of oil and gas developments. Ontario displays a loss in fiscal capacity under all three measures, reflecting shifts in economic activity and a relatively stable population. Ontario drops below the national average only when resources are fully considered. The extreme position of Alberta comes out clearly even allowing for its rapid increase in population. With natural resources included, Alberta soars from 37 per cent to 148 per cent above the national average. More interestingly, Alberta rises from 10 per cent to 36 per cent above the national average, even ignoring all natural resources. This demonstrates the strong shift in economic activity that is taking place under the stimulus of oil and gas developments.

Tax Effort

In developing similar indices for tax effort in the various provinces, relative revenue positions were related to relative tax base positions[2]. In other words, a province's actual tax effort is compared to the average tax effort for all provinces. Results are shown in Table A3. Considerable reductions in relative tax effort since 1972 are evident in Prince Edward Island and New Brunswick. Quebec is consistently relatively high, while Alberta is clearly anomalous in the GDP measure. By far the largest increase in tax effort during the period occurred in Newfoundland.

A separate index is shown in the table for the inclusion of municipal revenues, which are currently not part of the equalization formula[3]. Municipally-raised revenues vary significantly among the provinces and their effect on overall relative tax efforts cannot be ignored. The indices show the strong modifying effect in the Atlantic provinces where municipal revenue is of less importance. Alberta still remains some 25 per cent below the national average and is expected to drop further as a result of its effective elimination of municipal debt.

Table A3 also contains a special index of tax effort. For this calculation, provincial revenues are adjusted in respect of estimated deficits and surpluses. The resulting disparities in tax effort become quite extreme.

[2]For methodology, see technical note at the end of this Appendix.

[3]The indices shown can only be considered as a rough measure of the modifying effect, because of difficulties in finding reliable estimates.

Table A3

Indices of Relative Tax Effort, Selected Fiscal Years

(National Average = 100)

Measure of Tax Base	Nfld.	P.E.I.	N.S.	N.B.	Que.	Ont.	Man.	Sask.	Alta.	B.C.
Gross Domestic Product*										
1972-73	105	147	103	128	116	91	95	90	89	104
1976-77	115	108	91	99	114	87	91	99	111	107
1980-81	120	105	87	90	105	87	80	107	138	100
Representative Tax System										
All natural resource revenues at 100 per cent										
1972-73	93	140	101	120	119	97	99	93	77	93
1976-77	108	113	96	101	123	96	102	102	74	105
1980-81	114	114	96	96	122	101	100	108	80	94
All natural resource revenues excluded										
1972-73	97	136	101	122	119	97	100	93	69	91
1976-77	114	112	97	101	124	96	102	97	52	104
1980-81	124	114	97	98	124	102	100	97	54	91
All natural resource revenues excluded, municipal revenues added										
1972-73	82	117	95	105	115	98	100	98	79	92
1976-77	100	95	93	90	119	97	104	97	64	104
1980-81	103	92	90	85	122	99	99	97	66	97
All natural resource revenues excluded, municipal revenues and deficit (surplus) included										
1972-73	102	110	94	108	118	100	93	90	78	83
1976-77	126	92	93	100	127	102	105	90	31	96
1980-81**	135	99	104	89	134	107	103	91	14	94

Sources: Ontario Treasury.
Federal Department of Finance.
Statistics Canada, Catalogue 68-207.

*Total Revenues, including 100 per cent from natural resources.

**Surplus and deficit data used pertain to 1978-79.

Derivation of Shares of Weighted Comprehensive Tax Base and Tax Effort

The provincial shares of the weighted comprehensive tax base can be derived from the following formula used to determine total equalization entitlements:

$$E = TR\ (\%P - \%B)$$

where

E = total equalization entitlements

TR = total revenues of all provinces from revenue sources to be equalized

$\%P$ = province's share of total population

$\%B$ = province's share of total weighted comprehensive tax base.

Step 1 — Determine implicit aggregate fiscal capacity deficiency (%P – %B) by dividing total equalization entitlements (E) by the total revenues from revenue sources to be equalized (TR).

$$\frac{E}{TR} = (\%P - \%B)$$

Step 2 — Determine a province's share of the total weighted comprehensive tax base by subtracting the province's fiscal capacity deficiency or excess from its share of the population.

$$\%B = \%P - (\%P - \%B)$$

Step 3 — Index relative tax base per capita to the national average as follows:

$$I = \left(\frac{\%B}{\%P}\right) \times 100$$

Relative tax effort can be expressed as a province's actual revenues divided by the revenues that it would derive if it applied the national average provincial tax rate to its own revenue base. In short form, this is identical to dividing a province's share of total revenues by its share of total tax base.

$$\frac{\%TR}{\%B}$$

Relative tax effort can be indexed to the national average as follows:

$$I = \left(\frac{\%TR}{\%B}\right) \times 100$$

Equalization and Fiscal Disparities in Canada

Budget Paper A
Ontario Budget 1980

Equalization and Fiscal Disparities in Canada

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Equalization and Fiscal Disparities in Canada

Introduction

Canadians have long accepted the principle of inter-regional sharing of wealth and incomes. Programs are in place at the national level for putting into practice this vital principle. Through the revenues and expenditures of the federal government, substantial sums of money are transferred annually from the more affluent parts of the country to individuals, businesses, and governments in the less advantaged regions.[1] This system of sharing has relied on the federal government's historically pre-eminent position in the major revenue fields.

The rapid rise of oil and gas prices since 1973 has added a new dimension to the problem of inter-regional sharing. The massive transfer of purchasing power from the oil and gas consuming provinces to the producing provinces is limiting economic growth in the consuming regions. The flow of royalties has expanded the capacity of governments in the Western-most provinces to improve services and reduce taxes. On the other hand, the federal government finds itself without a sufficient share of oil and gas revenue sources to promote regionally balanced growth and development in Canada, and ensure reasonable harmony in provincial taxation levels. The economic and fiscal imbalances now emerging among the regions and governments of Canada will reach serious proportions in the 1980s unless further oil and gas price increases are accompanied by significantly revised arrangements for sharing and deploying the resource rents that are generated by higher prices.[2]

Energy developments have already begun to play havoc with the existing mechanisms of inter-regional sharing. This is nowhere clearer than in the important federal-provincial revenue equalization program, under which the federal government currently transfers more than $3 billion annually to the governments of the less wealthy provinces. The magnitude of the resource revenues flowing to the oil and gas producing provinces has already forced Ottawa into ad hoc adjustments to contain the costs of this program, and to preclude such anomalous results as

[1]See the Hon. W. Darcy McKeough, "Federal Fiscal Redistribution Within Canada", Budget Paper E, *Ontario Budget 1977* (Toronto: Ministry of Treasury, Economics and Intergovernmental Affairs, 1977).

[2]For Ontario's position on energy pricing and related arrangements, see the Hon. William G. Davis, *Oil Pricing and Security: A Policy Framework for Canada*, August, 1979.

Ontario suddenly qualifying as a "have-not" province. The result is a program that, while still sound in intent, is badly in need of reform. The current program expires on March 31, 1982.[3] A federal-provincial committee has already been established to develop proposals for reform to be considered by the Ministers of Finance.

This paper is a contribution by Ontario to the work of the committee, and to wider public understanding and debate. Its primary focus is the relationship between equalization and the distortions created by the energy situation. Part I reviews the current equalization formula as a background to the examination, in Part II, of the major problems posed by recent and future increases in the size of the Western resource royalties. Part III introduces a number of options for improving the program within the broader context of new approaches to inter-regional sharing.

1 Equalization: The Current Approach

The purpose of equalization payments was clearly expressed in 1966 by the Honourable Mitchell Sharp, Minister of Finance, when he said:

> "They represent one of the dividends of Canadian unity, designed as they are to enable all Canadians to enjoy an adequate level of provincial public services. Where circumstances — whether natural or man-made — have channelled a larger than average share of the nation's wealth into certain sections of the country, there should be a redistribution of that wealth so that all provinces are able to provide to their citizens a reasonably comparable level of basic services, without resorting to unduly burdensome levels of taxation."[4]

The equalization program is financed wholly by Ottawa, but the basis for federal calculation of entitlements is the comparative revenue raising capacity of provincial governments. This provides a measure of the relative fiscal strength of provinces.

Tables 1 and 2 indicate the significance of the equalization program. In 1979-80, $3.1 billion in equalization was paid to seven provinces. This amount represented approximately 18 per cent of federal personal income tax collections, 6 per cent of federal budgetary expenditures, or no less than one-quarter of all federal transfers to the provinces. As a national commitment, equalization has grown from 0.4 per cent of Gross National Product in the late 1950s to over 1.2 per cent in recent years. One-half of all equalization paid goes to Quebec, but in per capita terms Quebec receives much less than any of the Atlantic provinces. As well, it should be noted that in the Atlantic region payments this year will account for as much as 28 per cent of provincial budgetary revenues. This latter fact

[3]The program is authorized by Part I of the *Federal-Provincial Fiscal Arrangements and Established Programs Financing Act, 1977.*

[4]Statement by the Hon. M. W. Sharp to the Federal-Provincial Tax Structure Committee, Ottawa, September 14 and 15, 1966.

Growth of Equalization Payments — Table 1

Fiscal Year	Total Payments to Recipients	Annual Increase*	Share of GNP
	($ million)	(%)	(%)
1957-58	139	—	0.41
1966-67	355	11.0**	0.57
1967-68	552	55.6	0.83
1968-69	708	28.1	0.97
1969-70	849	20.0	1.06
1970-71	884	4.0	1.03
1971-72	940	6.4	0.99
1972-73	1,069	13.8	1.02
1973-74	1,482	38.6	1.20
1974-75	1,708	15.2	1.16
1975-76	1,877	9.9	1.13
1976-77	2,025	7.9	1.06
1977-78	2,587	27.8	1.24
1978-79	2,858	10.4	1.24
1979-80	3,118	9.1	1.21

*These percentages reflect numerous program changes.

**Nine-year average.

Equalization Entitlements, 1979-80 — Table 2

Provinces	Total Entitlement	Entitlement Per Capita	Percentage of Provincial Budgetary Revenue*
	($ million)	($)	(%)
Newfoundland	344	599	26
Prince Edward Island	79	644	28
Nova Scotia	419	495	26
New Brunswick	356	507	24
Quebec	1,574	250	12
Ontario	**	0	0
Manitoba	295	286	14
Saskatchewan	52	54	2
Alberta	**	0	0
British Columbia	**	0	0
Total Payable	3,118		

*As shown in provincial budgets, 1979-80.

**Non-recipient provinces.

helps explain the importance of federal-provincial negotiation when changes to this vital program are considered.

The current approach to equalization dates from 1967.[5] The present formula makes no attempt to define and cost the "basic public services"

[5]The standard reference is Douglas H. Clark, *Fiscal Need and Revenue Equalization Grants,* Canadian Tax Foundation, 1969.

and "comparable standards" that appear in the statement of objectives. Expenditure needs are simply assumed to be proportional to population. Moreover, no attempt is made to define or measure "unduly burdensome levels of taxation." Instead, the program focuses on compensating those provinces that have a revenue raising capacity below the national average.

There are two basic approaches to measuring revenue raising capacity, the income approach and the representative tax approach.[6] The *income approach* measures the aggregate "pool" of dollars that are available to be taxed, as indicated by personal income, total personal and corporate income, or Gross Domestic Product. The higher the income per capita, the greater the fiscal capacity. On the other hand, the *representative tax approach,* currently used for calculating equalization, takes actual tax structures into account in determining a province's ability to raise revenues. The two approaches do not always lead to the same conclusions. In fact, the energy situation has driven the two systems farther apart. Under an income approach, Ontario would be classified as a "have" province because of its above average per capita income. By contrast, under the representative tax system, it is now classified as fiscally deficient because of the current, overwhelming importance of the oil and gas revenue sources, none of which are available to Ontario.

Under the representative tax system of measuring revenue raising capacity, a representative tax base is defined for each provincial revenue source. For example, the national base for the retail sales tax is total retail sales in the provinces, minus sales of food, children's clothing and other items that are normally tax exempt. Each province's share of the combined provincial tax base is then subtracted from its share of the total Canadian population to derive either a *fiscal capacity excess* ("have" province) or *deficiency* ("have-not" province) in respect of that particular revenue source. This excess or deficiency is subsequently applied to the total revenues of *all* provinces from this revenue source to obtain either a negative or positive entitlement. To illustrate, Newfoundland's equalization entitlement in respect of the personal income tax in 1979 is computed as follows:

$$\begin{matrix}\text{Equalization}\\ \text{of personal}\\ \text{income tax}\end{matrix} = \begin{bmatrix}\text{all provinces'}\\ \text{revenues from}\\ \text{personal income tax}\end{bmatrix} \times \begin{bmatrix}\text{N's \% pop.} - \text{N's \% tax base}\end{bmatrix}$$

$$= [\$10{,}700 \text{ million}] \times [2.43\% - 1.30\%]$$

$$= \$121 \text{ million}$$

Equalization entitlements for each province are calculated in respect of all 29 revenue sources now used by the provinces, including

[6] See James H. Lynn, *Comparing Provincial Revenue Yields,* Canadian Tax Foundation, 1968.

nine separate natural resource revenue sources. Positive and negative entitlements are summed, and equalization is payable only if a province's net position is positive. For many years, Ontario, Alberta and British Columbia, despite being "have-not" provinces in certain revenue fields, had aggregate entitlements that were negative, and therefore did not qualify as recipients. Table 3 displays all of the revenue sources employed in the calculation process, and the positive and negative entitlements for each of the provinces in 1979-80. From this table, it can be ascertained, for example, that even though Newfoundland has a surplus capacity in mineral revenues and water power rentals, its overwhelming deficiencies in virtually all major revenue sources provide it with a large overall entitlement. Conversely, British Columbia's deficiency in Crown oil is significantly overshadowed by its excess capacities elsewhere.

The equalization formula determines simultaneously both the total amount payable by the federal government and the distribution by province. The system is driven by shifts in the economy, by provincial tax policy decisions, and by population changes. The commitment to equalize to the "national average" required that the formula be sufficiently open and flexible to respond to all of these circumstances. The formula thus left the federal government vulnerable to developments on the energy front.

II The Impact of Natural Resource Revenues

The rapid escalation of oil and gas revenues has put severe strains on the equalization program. The issues that have arisen include:

- Federal ability to pay;
- Ontario eligibility;
- The unique position of Alberta;
- The emergence of over-equalization; and,
- Inequitable funding arrangements.

Federal Ability to Pay

Since 1973, oil and gas revenues accruing to the producing provinces have increased substantially. To illustrate, Alberta's annual resource revenues jumped from $340 million in 1972 to nearly $4.7 billion in 1979. In contrast, the federal government has only limited access to revenues from natural resources.[7] The very sudden and rapid

[7]Under Section 91(2) of the British North America (BNA) Act, the federal government has the power to regulate trade and commerce, and under Section 91(3) it has wide taxing powers; but Sections 109, 117, 92(5) and 92(13) give the provinces ownership of natural resources and the capacity to "manage" these resources. Section 125 generally precludes the federal government from taxing a Crown agency, such as a provincial energy corporation or a heritage fund.

Equalization Entitlements by Revenue Source and Province, 1979-80

Table 3

($ thousand)

Revenue Sources	Nfld.	P.E.I.	N.S.	N.B.	Que.	Ont.	Man.	Sask.	Alta.	B.C.	Receiving Provinces
Personal Income Taxes	121,470	25,881	119,477	120,176	229,377	−425,853	93,058	85,914	−163,293	−206,206	795,353
Business Income Revenues	39,310	9,065	51,621	45,609	132,546	−64,902	20,032	20,180	−197,028	−56,433	318,363
General Sales Tax	42,075	10,241	47,448	32,577	183,737	−41,116	37,640	10,544	−206,530	−116,616	364,262
Tobacco Taxes	4,614	469	4,604	722	−19,935	14,595	4,084	6,075	−18,901	3,673	633
Gasoline Taxes	10,273	34	3,034	−1,423	22,756	−6,522	3,407	−3,339	−25,643	−2,578	34,742
Diesel Fuel Taxes	1,735	1,097	1,968	532	7,565	1,458	1,776	−2,060	−14,136	66	12,613
Non-Comm. Vehicle Licences	6,242	253	3,791	2,700	7,512	−4,573	−1,185	−7	−7,897	−6,837	19,306
Commercial Vehicle Licences	3,318	801	4,201	1,021	43,477	27,957	−4,545	−13,706	−47,605	−14,919	34,567
Revenues from Sale of Spirits	3,595	−703	−910	7,799	75,310	−23,046	−5,919	−5,686	−23,456	−26,984	73,486
Revenues from Sale of Wine	3,997	583	2,985	3,886	−5,012	2,671	1,838	3,873	−822	−14,001	12,150
Revenues from Sale of Beer	185	374	1,904	2,712	−11,490	−222	887	3,513	3,173	−1,037	−1,915
Hospital/Medical Ins. Premiums	4,639	799	1,162	1,980	21,534	−35,186	3,945	7,061	1,804	−7,737	41,120
Succession Duties/Gift Taxes	1,487	296	1,577	1,612	1,184	−6,155	1,456	784	−1,686	−554	8,396
Race Track Taxes	2,421	131	2,269	2,160	4,319	−13,710	871	3,148	−2,364	754	15,319
Forestry Revenues	−1,264	2,665	15,650	−1,800	43,487	108,804	17,679	13,581	32,730	−231,532	89,998
Crown Oil Revenues	29,055	6,216	42,869	35,474	318,837	430,249	49,826	−88,872	−917,241	93,587	393,405
Freehold Oil Revenues	1,482	317	2,186	1,809	16,257	21,483	632	−5,741	−44,871	6,445	16,942
Crown Gas Revenues	22,080	4,724	32,578	26,934	242,297	324,854	39,640	20,327	−684,043	−29,391	388,580
Freehold Gas Revenues	596	127	879	728	6,537	8,622	1,069	867	−22,014	2,589	10,803
Sales of Crown Leases*	6,724	1,439	9,921	8,212	73,790	99,524	12,072	−1,038	−185,716	−24,929	111,120
Other Oil and Gas Revenues	1,107	237	1,633	1,351	12,148	16,338	1,943	−1,261	−34,405	907	17,158
Mineral Revenues	−15,026	1,049	2,282	2,342	11,544	9,054	3,649	−12,135	9,963	−12,724	−6,295
Water Power Rentals	−9,285	294	1,841	1,182	−5,611	10,860	−1,642	1,675	4,366	−3,681	−11,546
Insurance Premium Taxes	2,392	359	1,995	1,105	−5,089	−1,370	1,539	1,467	−2,440	43	3,768
Payroll Taxes	5,190	1,162	4,255	4,561	9,869	−25,525	2,291	5,415	−1,539	−5,679	32,743
Property School Taxes	34,057	6,665	36,284	32,212	97,885	−111,411	2,960	−685	−56,947	−41,020	209,378
Lottery Revenues	1,991	336	1,399	1,589	3,880	−7,830	433	612	−205	−2,204	10,240
Miscellaneous Provincial Taxes	19,112	4,142	19,700	17,538	56,695	−53,982	5,305	737	−50,735	−18,512	123,229
Shared Federal Revenues	270	0	340	295	−1,018	−17	76	274	−227	8	237
Total Entitlement	343,842	79,053	418,943	355,595	1,574,388	255,049**	294,817	51,517	−2,657,708**	−715,502**	3,118,155

*Reflects first stage of two year phase-out.

**Ontario not included in aggregate for receiving provinces. A negative total does not represent a liability but rather a zero entitlement.

increases in revenue from oil and gas for a few provinces have therefore placed a severe strain on the federal government's ability to pay the resulting equalization.

Equalization entitlements in total have grown by 16 per cent a year since 1972, considerably outpacing growth in the economy generally. More significant, however, has been the growth of the payments relating to the natural resource revenues. Despite limiting features discussed below, these payments grew by 29 per cent per year over the period, and their share of total equalization grew from 17 per cent in 1973 to over 30 per cent in 1979. As shown in Table 3, oil and gas revenues already generate substantially more equalization than the corporate and retail sales taxes combined. Yet oil and gas revenues account for only 7 per cent of provincial revenues to be equalized.

The massive levering effect of oil and natural gas revenues on equalization is explained by their uneven distribution among the provinces, as well as by the fact that the greater proportion of the country's population resides in the consuming regions. In respect of oil and natural gas, seven provinces, with over 75 per cent of the national population, have a share of the tax base which is effectively zero.This means they have an entitlement equal to their population share of the equalized oil and gas revenues of the producing provinces. The inescapable result is very high federal payment liabilities. To illustrate, in the absence of any constraints, a $1.00 increase in Crown gas revenues would currently generate a federal obligation of over 78 cents in equalization, whereas a $1.00 increase in non-resource revenues would generate less than 7 cents.[8]

With no built-in indication of what provinces really require for the "basic" public services, there is no upper bound on how much equalization should be paid. With need implicitly defined as the population share of total provincial revenues, and with provincial oil and gas revenues skyrocketing, equalization payments could have grown without limit. This threatened a situation where huge federal tax increases would have been required as a consequence of provincial oil and gas fortunes just to pay the additional equalization. Without any constraints, equalization would have risen to over $5.6 billion in 1979-80, almost $2.5 billion more than has actually been paid.

The federal government, recognizing that it did not have a sufficient share of the oil and gas revenue sources to be able to afford such enormous resource generated increases in equalization, therefore acted quickly to contain the impact of resource revenues on the equalization program. In the first of several ad hoc responses, it "froze" oil and gas royalties at their 1973-74 level, adjusted for volume, and

[8]In the extreme, if all oil and natural gas were located in Prince Edward Island, every dollar increase in royalties flowing to the P.E.I. government would produce federal equalization liabilities of over 99 cents.

between 1974 and 1977 equalized only one-third of the royalties above that level. In the 1977 Federal-Provincial Fiscal Arrangements and Established Programs Financing Act, revenues from non-renewable natural resources were declared equalizable to the extent of 50 per cent of their value, and equalization in respect of all natural resources was limited to one-third of total equalization payable. Finally, partly as an economy measure, and partly to forestall Ontario's entry into equalization, the federal government decided to eliminate, over a two-year period, the revenue source called "Sale of Crown Leases." This measure alone is estimated to reduce equalization payments by $111 million in 1979-80 and double this amount in 1980-81.

Ontario Eligibility

Another result of natural resource developments is that, in the absence of another ad hoc measure, Ontario would become eligible for equalization under the representative tax formula.

According to the latest calculations, Ontario would be entitled to a total of $567 million in respect of the fiscal years 1977-78, 1978-79 and 1979-80. A conservative estimate for 1980-81 puts the Ontario entitlement at $250 million for a cumulative amount of over $800 million. The fact that Ontario would be eligible, even with non-renewable resource revenues discounted by 50 per cent, indicates that the current formula no longer makes sense in terms of its basic objectives. On the tax capacity side, the income approach affirms that this province is still well within the "have" category; personal income per capita in Ontario in 1979 is estimated to be 9 per cent above the national average. And, if an objective measure could be developed, there is little question that Ontario would be shown to rank among the highest in terms of the provision of basic services.

To make certain that Ontario would not receive equalization, the federal government introduced legislation in late 1978 which would have precluded a province from receiving equalization payments if it had a per capita income above the national average in each of the prior three years. This legislation died on the Order Paper of the 30th Parliament, but identical legislation is to be introduced into the 32nd Parliament with retroactive effect. Ontario has thus far accepted it should not qualify for equalization related to the provision of "basic" public services — but, as suggested below, the current level of equalization is doing more than just helping with the provision of such services.

The Unique Position of Alberta

The new-found wealth of the producing provinces is remarkable. Even at present oil and gas prices, Alberta's oil and gas revenues are approaching $5 billion per year. Saskatchewan receives over $300

million in oil revenues, and British Columbia takes in more than $400 million from its natural gas sources.

Alberta already has among the best provincial and local government services in Canada. It has no sales tax, no gasoline tax, no residential property tax for school purposes, and by far the lowest individual and corporate income taxes. Its 1979 budget retired virtually all municipal debt. In fact, Alberta could abolish all its conventional tax sources, and still have access to more revenues on a per capita basis than most other provincial governments. This is the situation today, with Canadian oil prices at half world levels. Moreover, economic growth and diversification built on the energy base are leading to a rapid improvement in Alberta's relative fiscal capacity in most of the conventional tax sources. To illustrate, Alberta's share of the population increased by less than 2 percentage points between 1972 and 1979, yet its share of the personal income tax base grew from 7 per cent to 10 per cent; its share of the corporate income tax base grew from 9 per cent to 16 per cent; and, while it has no retail sales tax, its share of the retail sales tax base grew from 9 per cent to 12 per cent. In the latter two sources, Alberta was already significantly above the national average in 1972.

Table 4 indicates the fiscal disparities that could emerge in Canada over the next several years, assuming alternative energy price increases but no fundamental restructuring of current revenue flows. Revenues have been projected on the basis of regional economic forecasts, while expenditures have been assumed to grow no faster than GNP in the consuming provinces and somewhat faster than this in Alberta. Under price increases of two dollars per annum, the surplus of the producing provinces will be about $5.0 billion in 1981-82, while the deficits of the other provinces will exceed $3.9 billion. Under price increases of four dollars per annum, the surpluses climb to over $6.5 billion and the deficits reach $4.1 billion. The total disparity, or fiscal gap, between the surplus and deficit provinces could easily double within two years. These projections imply even greater disparities in growth, taxes and service levels between Alberta and the other provinces than exist at the present time.

The Economic Council of Canada has recently expressed concern about the unprecedented fiscal imbalances that are emerging in Canada.[9] Unchecked, these imbalances will inevitably lead to new tensions in Confederation. Over previous decades, the federal government has sought to modify regional disparities, ensure economic stability, and achieve nation-wide sharing of the benefits of economic growth. This was made possible by the federal government's access to the main revenue sources, and by the fact that the majority of the population lived in the dynamically growing regions. With insufficient

[9]The Economic Council of Canada, *Two Cheers for the Eighties,* Sixteenth Annual Review, 1979, chapter 4.

Growing Fiscal Disparities

($ million)

Table 4

			Projections Under Increase in Domestic Oil Price of			
			$2 per annum		$4 per annum	
	1978-79	Estimated 1979-80	1980-81	1981-82	1980-81	1981-82
Oil and Gas Provinces' Annual Surpluses	+2,347	+2,400	+4,300	+5,000	+5,100	+6,550
Other Provinces' Annual Deficits	−2,605	−2,050	−3,200	−3,950	−3,325	−4,100
Total Fiscal Disparity between Producing and Non-Producing Provinces	4,952	4,450	7,500	8,950	8,425	10,650
Net Fiscal Position of Provincial Sector	−258	+350	+1,100	+1,050	+1,775	+2,450
Federal Deficit	−12,103	−11,500	−12,000	−12,600	−12,300	−13,400
Net Fiscal Position of Federal-Provincial Sector	−12,361	−11,150	−10,900	−11,550	−10,525	−10,950

Source: Ontario Treasury projections based on data using a modified Financial Management Series concept.

Notes:
1. Economic performance over the projection period in the base case ($2 per barrel or equivalent) is assumed to be similar to the average achieved over the past five years.
2. Revenue yields are related to the performance of key economic variables and energy prices.
3. Expenditures are projected to grow at 1 percentage point less than nominal growth in the national economy. This is in keeping with the commitment made by the First Ministers to hold spending below the rate of growth of the national economy. Alberta's spending is assumed to grow at 3 percentage points above the rate in other provinces in recognition of its rapid economic growth and need for infrastructure.
4. The 1979-80 surplus shown for producing provinces is substantially underestimated due to the Alberta extraordinary expenditure of approximately $1 billion re municipal debt retirement.

fiscal capacity in the natural resource fields, and the base of growth too narrowly concentrated, the long run ability of the federal government to ensure inter-regional sharing is being seriously undermined.

As noted earlier, the growing economic and fiscal disparities between the producing and consuming provinces underscore the need for new arrangements for inter-regional sharing. In addition, the Western royalty fortunes have distorted the very meaning of "comparable services" implicit in the current equalization program. Previously accepted notions of basic services have been "levered up" because the equalization formula generated entitlements unconstrained by agreed measures of need. In other words, the traditional recipient provinces began to receive an equalization "windfall" as a result of increases in the price of oil and gas.

Until the early 1970s, it was reasonable to assume that the national average would be determined by British Columbia, Ontario and Quebec, given that these provinces collectively account for nearly three-quarters of the total population of the country. However, when the norms can be so radically skewed by a province with less than 9 per cent of the population, the real objectives of the program begin to lose their focus. In fact, this levering effect is understated because of the low tax effort in Alberta — were Alberta to impose national average tax rates, equalization to the poorer provinces would, of course, go up even further. To address the extreme inequality created by a super-rich province with a small share of the population, all provinces could in theory be equalized to the revenue raising capacity of the wealthiest province. However, with the present formula, this would require a doubling of the federal government's total revenues.

The Emergence of Over-Equalization

The continued inclusion of rapidly growing oil and gas revenues may have resulted in over-equalization of the current recipient provinces. As explained, these provinces have by and large enjoyed fairly dramatic increases in equalization even though the demands for, and costs of, provincial government services may not have gone up proportionately. Moreover, this process has been superimposed on a long history of implicit equalization, under which the poorer provinces received effectively higher rates of cost-sharing support,[10] and relatively generous assistance through the federal-provincial programs falling within the mandate of the Department of Regional Economic Expansion.

In 1976, the federal government stated that "the present equalization formula provides a level of payment that appears to be meeting the

[10] See the Hon. Charles MacNaughton, "The Structure of Public Finance in Ontario", Budget Paper B, *Ontario Budget 1970* (Toronto: Ontario Department of Treasury and Economics, 1970).

program's objective."[11] If this is accepted, it might be inferred from the recent, relatively high equalization growth rates to certain recipients that the program is now over-delivering to some extent. Also, the representative tax system in 1979-80 delivered to the recipient provinces some $628 million more than they would have received under an income approach based on provincial Gross Domestic Product. In a similar vein, Ontario's eligibility under the representative tax system strongly suggests that considerable over-equalization has taken place since energy prices first erupted in 1973.

Provincial Government Revenues by Province — Table 5

($ per capita)

	Nfld.	P.E.I.	N.S.	N.B.	Que.*	Ont.	Man.	Sask.	Alta.	B.C.
1973-74	1,045	1,223	969	1,050	889	935	958	991	1,176	1,022
1974-75	1,291	1,398	1,113	1,213	1,280	1,108	1,110	1,409	1,872	1,233
1975-76	1,476	1,664	1,293	1,419	1,451	1,226	1,314	1,591	2,089	1,367
1976-77	1,674	1,794	1,458	1,522	1,699	1,418	1,524	1,766	2,535	1,662
1977-78	1,877	1,946	1,599	1,612	1,942	1,489	1,590	1,964	3,260	1,873
1978-79	2,071	2,022	1,772	1,862	2,142	1,636	1,714	2,225	3,987	2,047
1979-80	2,316	2,218	1,972	2,072	2,420	1,820	1,988	2,456	4,585	2,350

Source: Data up to 1976-77 are based on Statistics Canada, Catalogues 68-202 and 68-207. Data for subsequent years are Ontario Treasury estimates.

*Quebec data exclude Quebec Pension Plan collections.

Consolidated Provincial-Local Government Revenues by Province — Table 6

($ per capita)

	Nfld.	P.E.I.	N.S.	N.B.	Que.*	Ont.	Man.	Sask.	Alta.	B.C.
1973-74	1,091	1,279	1,152	1,097	1,254	1,220	1,205	1,251	1,494	1,306
1974-75	1,355	1,431	1,308	1,263	1,533	1,425	1,412	1,678	2,207	1,556
1975-76	1,568	1,751	1,519	1,501	1,735	1,598	1,690	1,902	2,472	1,769
1976-77	1,810	1,894	1,691	1,641	2,042	1,862	1,971	2,144	2,986	2,143
1977-78	2,011	2,074	1,860	1,733	2,299	1,992	2,070	2,408	3,861	2,400
1978-79	2,214	2,198	2,054	1,981	2,538	2,184	2,279	2,713	4,629	2,647
1979-80	2,466	2,398	2,288	2,203	2,861	2,411	2,602	2,988	5,231	2,994

Source and Footnote: See Table 5.

Table 5 presents data on the per capita revenues available to provincial governments. This information has to be interpreted very carefully, inasmuch as it subsumes important structural differences among the provinces. Nevertheless, it is interesting to note that Ontario has the lowest per capita revenues of any province, and that the gap between the Eastern provinces and Ontario has actually widened over the decade. Table 6 presents data on the per capita revenues of provincial and local governments combined. In this comparison, only the three Maritime provinces record per capita revenues slightly below those in Ontario. Furthermore, if municipal revenues were equalized,

[11]The Hon. D. S. Macdonald, "Notes for a Statement on the Provincial Revenue Equalization Program", Meeting of Federal-Provincial Ministers of Finance and Treasurers, July 6, 1976.

Ontario would undoubtedly come close to having the lowest revenue per capita here too.

As provincial governments vary in terms of deficits and surpluses, similar comparisons are made for per capita spending in Tables 7 and 8. Ontario is the lowest in respect of provincial government spending, and is surpassed by all except the three Maritime provinces in respect of spending by the provincial-local sector as a whole.

Provincial Government Expenditures by Province — Table 7
($ per capita)

	Nfld.	P.E.I.	N.S.	N.B.	Que.	Ont.	Man.	Sask.	Alta.	B.C.
1973-74	1,142	1,209	976	1,033	1,022	972	949	882	1,035	913
1974-75	1,459	1,421	1,121	1,274	1,256	1,193	1,141	1,188	1,379	1,216
1975-76	1,794	1,752	1,364	1,535	1,582	1,402	1,394	1,457	1,690	1,556
1976-77	1,924	1,793	1,493	1,649	1,773	1,542	1,582	1,710	2,022	1,597
1977-78	2,081	2,029	1,652	1,832	1,948	1,671	1,748	1,902	2,287	1,760
1978-79	2,242	2,108	1,843	1,977	2,171	1,784	1,770	2,094	2,586	1,926
1979-80	2,556	2,216	2,068	2,184	2,390	1,941	2,008	2,305	3,405	2,159

Source: Data up to the end of 1976-77 are based on Statistics Canada, Catalogues 68-202 and 68-207. Data for subsequent years are Ontario Treasury estimates.

Notes: 1. Expenditures related to the Quebec Pension Plan and Quebec Family and Youth Allowances have been eliminated in order to be comparable with the other provinces.

2. The growth rate for Alberta provincial per capita expenditures in 1979-80 is larger than for consolidated expenditures because the former includes the provincial expenditures involved in the municipal debt reduction program.

Consolidated Provincial-Local Government Expenditures by Province — Table 8
($ per capita)

	Nfld.	P.E.I.	N.S.	N.B.	Que.	Ont.	Man.	Sask.	Alta.	B.C.
1973-74	1,195	1,322	1,173	1,111	1,264	1,302	1,197	1,146	1,370	1,300
1974-75	1,534	1,456	1,365	1,377	1,555	1,566	1,481	1,509	1,802	1,611
1975-76	1,908	1,879	1,654	1,684	1,863	1,832	1,837	1,835	2,201	2,015
1976-77	2,089	1,869	1,773	1,847	2,190	2,020	2,095	2,153	2,637	2,171
1977-78	2,245	2,142	1,972	2,015	2,381	2,216	2,257	2,413	3,151	2,426
1978-79	2,311	2,262	2,295	2,317	2,630	2,378	2,397	2,635	3,598	2,675
1979-80	2,620	2,374	2,460	2,357	2,889	2,579	2,694	2,863	4,050	3,026

Source and Notes: See Table 7.

Inequitable Funding Arrangements

The aforementioned issues taken together suggest that the financing of equalization has become inequitable. Federal taxpayers in Ontario end up paying a large part of the bill for the increasing equalization that automatically flows to the East as a result of the increased royalties to the West.[12] At the same time, those who benefit most

[12] If 1973-74 is taken arbitrarily as a base year, and energy-generated equalization is constrained to grow at the rate of increase of non-energy equalization, "windfall" equalization can be isolated as, very roughly, $525 million in 1979-80. Taxpayers in Ontario would account for about $225 million of this. Thus, each person in Ontario could be said to be paying $25 extra to subsidize people in the recipient provinces, as a result of price developments in oil and natural gas.

from natural resource revenues escape paying a commensurate share of the cost, and those who receive windfall equalization are able to expand services beyond the traditionally accepted "basic level." Table 9 displays certain financial flows relating to oil and gas. Each two dollar increase in the price of oil is estimated to drain $640 million out of the Ontario economy directly. But, currently, there is an additional drain of over $70 million to finance federal equalization payments to the recipient provinces. Thus, while the recipient provinces receive partial compensation for energy price increases, Ontario taxpayers end up paying twice. In this sense, the current equalization formula has become an unintended and unfair method of inter-regional sharing. Various commentators have noted this "serious inequity in funding equalization flows arising from energy."[13] It should also be noted that federal taxpayers in Ontario already bear a healthy share of the financing for the Oil Import Compensation Program. Some of the financial flows related to energy are shown and discussed in the Appendix.

When the one-third resource ceiling is reached, the growth of equalization will no longer be determined by the growth of resource related revenues. It will, instead, tend to settle in around the general rate of growth in the economy as a whole, as reflected through the non-resource revenue sources. (Table 10 displays the impact of the one-third cap under two oil and gas price assumptions for 1980 and 1981.) One important consequence is that the equalization formula will cease to be even the partial and indirect mechanism by which the traditional receiving provinces have, for seven years, been able to "share" in the rapidly increasing wealth of the producing provinces. The obvious result, given further energy price increases, will be a more rapidly widening fiscal gap between the producing and consuming provinces, and an even greater need for a new national approach to rent sharing.

III Equalization: Reform Scenarios

A thorough reform of the equalization program is required as part of the solution to Canada's problems of regional imbalance. This fact has been recognized for some time. During 1976, the federal government contemplated major structural changes to the formula, but concern on the part of the recipients, combined with the complex Established Programs Financing negotiations being conducted simultaneously, precluded this step.[14] Since 1977, the equalization program has become even less satisfactory as a result of the arbitrary provisions that have been introduced.

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[13]T.J. Courchene, "Energy and Equalization", *Energy Policies for the 1980s,* Ontario Economic Council, 1980, p. 129.

[14]For a review, see the Hon. W. Darcy McKeough, "Federal-Provincial Fiscal Reforms", Budget Paper B, *Ontario Budget 1977* (Toronto: Ministry of Treasury, Economics and Intergovernmental Affairs, 1977).

Table 9

Impact of a $2 Per Barrel Rise in the Price of Oil

($ million)

	Nfld.	P.E.I.	N.S.	N.B.	Que.	Ont.	Man.	Sask.	Alta.	B.C.	Total
Additional cost for oil and natural gas	37.0	8.0	69.0	62.0	404.0	640.0	65.0	84.0	252.0	179.0	1800.0
Royalties received	—	—	—	—	—	2.0	3.0	56.0	755.0	64.0	880.0
Equalization generated	10.7	2.3	15.8	13.1	117.4	—	18.3	−14.7	—	—	162.9
Estimated contribution from federal taxpayers in support of this new equalization	1.5	0.4	4.4	2.9	36.0	70.8	5.6	5.0	18.1	18.2	162.9
Net balance	−27.8	−6.1	−57.6	−51.8	−322.6	−708.8	−49.3	−47.7	+484.9	−133.2	
Net balance in $ per capita	−48	−50	−68	−74	−51	−83	−48	−50	+241	−52	

Notes: 1. "Estimated contribution from federal taxpayers" is calculated as per 1978 federal revenue collections in each province, National Accounts basis. See Statistics Canada, Catalogue 12-213.

2. The reduction in the cost of the Oil Import Compensation Program and the reduced yield from export charges are ignored.

3. Table does not take into consideration increased purchasing power of the oil and gas industry.

Table 10

Impact of Resource Cap on Equalization Entitlements

($ million)

	Nfld.	P.E.I	N.S.	N.B.	Que.	Ont.*	Man.	Sask.	Total*	Growth over Previous Year*
No Cap										(%)
1980-81 $2.00/barrel	391.0	91.6	481.5	415.6	1,793.6	403.2	332.9	68.9	3,575.0	14.6
$4.00/barrel	401.5	93.8	496.8	428.5	1,905.0	546.0	350.2	60.9	3,736.7	19.8
1981-82 $2.00/barrel	442.3	103.6	544.1	471.4	2,014.6	495.0	383.7	77.0	4,036.8	12.9
$4.00/barrel	461.3	107.7	571.9	494.6	2,213.7	754.9	414.7	63.8	4,327.6	15.8
With Cap										
1980-81 $2.00/barrel	387.7	90.2	472.7	409.4	1,735.4	320.2	323.0	73.7	3,492.0	12.0
$4.00/barrel	392.0	90.2	473.2	411.4	1,746.4	321.3	323.4	74.1	3,510.6	12.6
1981-82 $2.00/barrel	432.5	99.7	518.8	453.3	1,845.9	255.4	355.0	90.3	3,795.5	8.7
$4.00/barrel	444.4	101.8	533.1	466.2	1,950.6	384.3	370.5	84.4	3,950.9	12.5
Loss from Cap										
1980-81 $2.00/barrel	3.3	1.4	8.8	6.2	58.2	83.0	9.9	(4.8)	83.0	
$4.00/barrel	9.5	3.6	23.6	17.1	158.6	24.7	26.8	(13.2)	226.1	
1981-82 $2.00/barrel	9.8	3.9	25.3	18.1	168.7	239.6	28.7	(13.2)	241.3	
$4.00/barrel	16.9	5.9	38.8	28.4	263.1	370.6	44.2	(20.6)	376.7	

Source: Ontario Treasury estimates.

*The totals and growth rates exclude Ontario due to pending federal legislation.

Note: Numbers may not add due to rounding.

The problems and issues raised in this paper indicate the need to restore equalization as a program that is concerned with "comparable standards of service" at tax rates that are not "unduly high". For 1982, this could mean removing or reducing the influence of non-renewable resources on the formula. Consideration will also have to be given to new mechanisms for ensuring that, in future, all provinces are treated fairly when it comes to redistributing the windfall revenues generated by oil and gas. Such mechanisms could well entail direct contributions by wealthy provinces toward the national equalization effort.

Various reform proposals have been put forward by governments and public finance specialists in the past few years. These proposals range from comprehensive packages to suggestions for resolving specific issues. This paper suggests four scenarios that appear appropriate for further study and discussion by the federal and provincial governments. Tables 11 and 12 compare the dollar flows under each option for 1979-80 and 1981-82. The options will clearly have to be analyzed against the backdrop of dynamically changing oil and gas developments.

Scenario I

Under this scenario, the need for the one-third cap and the per capita override would disappear because of a change in the method of determining fiscal capacities.

Main Features

- Fiscal capacities would be calculated by comparing a province's share of the population with its share of provincial Gross Domestic Product.
- Equalization entitlements would be calculated by applying the fiscal capacity deficiencies to total provincial revenues, continuing to discount non-renewable resources by 50 per cent.
- Provinces would receive, over a guarantee period, the greater of the equalization so determined, or the equalization they received in the final pre-reform year.

This option would, over time, eliminate the windfall equalization that has occurred due to the escalation of oil and gas prices since 1973. The guarantee is added to prevent the significant losses that would otherwise occur for certain provinces in the first years as a result of the reform. There would, during the guarantee period, be zero growth in payments to Quebec and Manitoba, meaning that the federal government would achieve substantial savings on the program. This scenario does not address the question of petrodollar recycling, and assumes that separate mechanisms would be put in place to handle the sharing of natural resource rents as prices rise. This option is displayed in column 2 of Tables 11 and 12.

Scenario II

Under this scenario, there would be two equalization formulas, one for conventional revenue sources and one for natural resources.[15] This would recognize the very uneven distribution of resources among the provinces, and isolate basic equalization from the dollar flows generated by oil and gas. The second tier of equalization could then be financed by contributions from the resource wealthy provinces.

Main Features

- The present equalization formula would be applied to all revenue sources, excluding natural resources.
- Municipal property taxes would be added.
- The federal government would save about $800 million per year, which it could devote to energy conservation and development, oil import subsidies, etc.
- A second tier of equalization would involve provincial financing.
- Provinces would contribute 25 per cent of the portion of their natural resource revenues in excess of the per capita national average.
- Provinces would receive 25 per cent of their natural resource deficiencies relative to the per capita national average.

This approach establishes " basic" equalization at roughly the level it would have reached in the absence of energy price shocks. The funding inequity associated with past oil and gas price increases is thereby removed. The governments of the resource wealthy provinces contribute directly and visibly to the national equalization effort. The potential strain of further energy price increases on federal finances is eliminated, without resort to arbitrary caps, and a measure of rent recycling takes place automatically as oil and gas prices rise. The breakout between basic and resource equalization under this option is displayed in columns 3 and 4 of Tables 11 and 12.

Scenario III

Under this scenario, there would be two separate redistribution systems, one for basic equalization, and one a per capita grant financed largely from natural resource revenues. Structurally, this option is similar to Scenario II, except that it avoids the concept of "equalizing" in respect of natural resources. Rather, it is based on the notion that natural resources, while owned and managed by the provinces, are in certain respects a national heritage of all Canadians. It follows that when part of the windfall revenue is being shared, it should be distributed on a population basis.

[15]For discussion of one such two-tier formula, see Thomas J. Courchene and Glen H. Copplestone, "Alternative Equalization Programs: Two Tier Systems", paper prepared for Canadian Tax Foundation Conference on "The Fiscal Dimension of Canadian Federalism", October 12, 1979.

Main Features

- As under Scenario II, natural resources would be removed from the representative tax system, and municipal property taxes would be added.
- Federal "savings" of $800 million would be committed to a new national sharing fund.
- Provinces would add to this fund 25 per cent of the portion of their natural resource revenues in excess of the per capita national average.
- The total in this separate fund would be distributed to all provinces on a per capita basis.
- For simplicity, the base-year federal "savings" committed to the new fund could be put on an indexed basis, rather than annually recalculated relative to the old formula.

This scenario very clearly distinguishes basic equalization from rent sharing. All provinces would be entitled to their population shares of part of the national resource heritage. As energy prices rise, relative to the index, the portion of the fund contributed by the resource wealthy provinces would increase.

Scenario IV

This scenario assumes that the equalization program becomes a formal mechanism for the partial recycling of petrodollars. It leaves substantially intact the existing representative tax system approach, but removes most of the ad hoc measures introduced in recent years to contain the program's sharp cost escalation. In order to prevent a further deterioration in the federal financial position, the federal contribution to the program in the final pre-reform year would be placed on an acceptable index basis. And, the oil and gas producing provinces would share the excess costs of the program taking into account their relative fiscal superiorities.

Main Features

- The one-third ceiling and the per capita override would be removed. Crown leases would be put back in. Non-renewable resources would continue to be discounted by 50 per cent.
- This "unconstrained" representative tax system would be allowed to run full out.
- Federal liability would be set at a base-year dollar amount, escalated by, say, GNP growth.
- The shortfall between program costs and federal liability would be paid by wealthy provinces on the basis of their shares of the total fiscal capacity excess.

As a scenario for the future, this option makes a substantial difference to the traditional recipients as their entitlements will no longer be

constrained by the one-third ceiling and per capita override. The producing provinces will directly contribute part of their petrodollar fortunes to the rest of Canada as prices are allowed to rise. Thus, like Scenarios II and III, this option has a built-in mechanism for recycling. In fact, the 50 per cent discount on non-renewable resources could be abolished to make this an even stronger recycling program.

The last three alternatives discussed above entail voluntary provincial contributions to a national program or fund. This would not, of course, affect the ownership of resources, and would only come about as part of an overall energy pricing agreement. Resource related transfers under these scenarios should not be regarded as the means for reducing deficits or further expanding the public sector. On the contrary, the objective is that these funds be constructively passed through to the private sector to offset the drain of purchasing power due to higher energy prices. This recycling via the provinces would complement any recycling to be undertaken by the federal government through proposed energy banks, reinvestment funds, or whatever other institutions emerge as the flow of resource rents is renegotiated. It would ensure that all provinces continue to have an effective voice in developing responses to the economic challenges posed by higher domestic energy prices.

Conclusion

The rapid rise in oil and natural gas prices since 1973 has caused serious differences in economic performance among the regions, and serious fiscal imbalances among governments in Canada. This paper has examined the equalization program and its relationship to energy developments and inter-regional sharing. The current formula is clearly inappropriate and arbitrary in its treatment of resource revenues, and is in need of significant reform. The renegotiation of the equalization program will test the ability of Canadians to meet the new regional and fiscal challenges to Confederation in the 1980s.

Table 11

Comparison of Various Equalization Approaches, 1979-80

($ million)

	Present	Scenario I	Scenario II			Scenario III			Scenario IV
		(Before Guarantee)	Basic Equalization	Resource Equalization	Total	Basic Equalization	Resource Fund	Total	
Nfld.	344	386	342	36	378	342	48	390	351
P.E.I.	79	84	69	8	77	69	10	79	80
N.S.	419	398	345	58	403	345	71	416	429
N.B.	356	354	311	44	355	311	59	370	364
Que.	1,574	1,146	953	414	1,367	953	528	1,481	1,648
Ont.	0	0	0	554	554	0	712	712	355
Man.	295	107	173	63	236	173	86	259	307
Sask.	52	15	124	−58	66	124	80	204	50
Alta.	0	0	0	−1,031	0	0	168	168	0
B.C.	0	0	0	−88	0	0	215	215	0
Total	3,118	2,490	2,317	—	3,436	2,317	1,977*	4,294	3,584**

*Under Scenario III, Saskatchewan pays $58 million, Alberta $1,031 million, British Columbia $88 million and the federal government $800 million.

**For illustrative purposes, assumes $2,587 million in 1977-78 and an escalator of 9 per cent to 1979-80. Under these assumptions, the federal government pays $3,074 million, Alberta pays $236 million and British Columbia pays $64 million.

Table 12

Comparison of Various Equalization Approaches, 1981-82

($ million)

	Present	Scenario I	Scenario II			Scenario III			Scenario IV*
		(Before Guarantee)	Basic Equalization	Resource Equalization	Total	Basic Equalization	Resource Fund*	Total	
Nfld.	444	485	426	63	489	426	76	502	477
P.E.I.	102	106	89	14	103	89	16	105	110
N.S.	533	512	438	97	535	438	111	549	595
N.B.	466	475	404	77	481	404	92	496	514
Que.	1,951	1,494	1,136	703	1,839	1,136	818	1,954	2,386
Ont.	0	0	0	950	950	0	1,111	1,111	989
Man.	371	160	217	112	329	217	133	350	443
Sask.	84	0	156	−82	74	156	126	282	64
Alta.	0	0	0	−1,832	0	0	275	275	0
B.C.	0	0	0	−102	0	0	343	343	0
Total	3,951	3,232	2,866	—	4,800	2,866	3,101	5,967	5,578**

*Under Scenario III, Saskatchewan pays $82 million, Alberta $1,832 million, British Columbia $102 million and the federal government $1,085 million.

**Assumes $3,118 million in 1979-80 and an escalator of 10 per cent to 1981-82. Under these assumptions, the federal government pays $3,773 million, Alberta pays $1,505 million and British Columbia pays $300 million.

Note: For illustrative purposes of future price effects, a $4.00/barrel price increase for 1980 and 1981 is assumed.

Appendix

This Appendix describes the main inter-regional dollar flows associated with oil and gas in 1979, and highlights the considerable energy burden borne by federal taxpayers in Ontario.

As shown in the accompanying diagram, there are three avenues of subsidization leading from the federal government. Under the Oil Import Compensation Program, Ottawa spent over $1,575 million to effectively bring down the price of imported oil in Eastern Canada to the fixed domestic price. Under the equalization program, $938 million in energy-related equalization flowed to the recipient provinces – most of it was directed to the provinces east of Ontario, but some flowed to Manitoba and Saskatchewan. The arrow labelled "tax incentives to the resource industry" summarizes a variety of federal tax expenditures. There are considerable conceptual difficulties in measuring the value of these incentives. An extremely conservative estimate for 1979 is $600 million.

While tax incentives ultimately benefit shareholders wherever they may live, they are considered in this Appendix to benefit the West in that their very existence testifies to income producing activity in the oil producing areas. Furthermore, there is evidence for recent years that provinces have been able to capture a significant portion of these incentives. For example, excess corporate liquidity helped to trigger a recent bidding war for exploration rights and a resultant spectacular increase in provincial revenues from the sale of Crown leases.

The three main avenues of federal subsidy can be traced back through the federal tax structure to their effective point of origin. Federal taxpayers in Ontario generate about 43 per cent of federal general revenues, while taxpayers east of Ontario provide 28 per cent, and taxpayers west of Ontario account for 29 per cent. Applying these percentages to the cost of the federal redistribution effort determines contributions as follows:

($ million)	West	Ontario	East	Total
Oil Import Deficit	244	361	235	840
Energy Equalization	272	403	263	938
Tax Incentives	174	258	168	600
Total	690	1,022	666	2,378

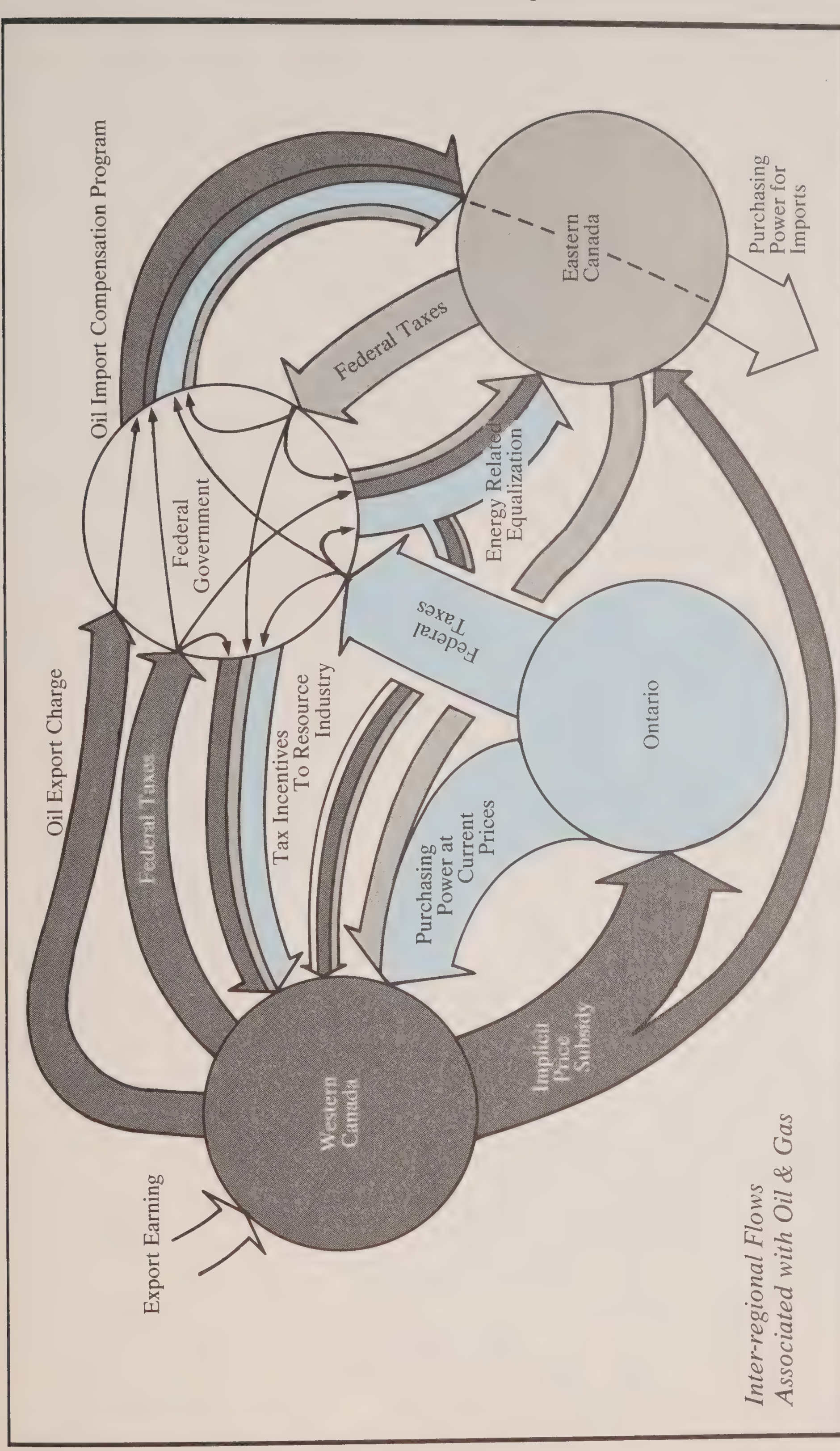
In addition, Western Canada is assumed to contribute the full value of the Oil Export Charge, $735 million, since, in the absence of this federal measure, most of the benefits of the export price would accrue to the provincial governments and industry.

Eastern Canada receives a total energy related subsidy of \$2,387 million, composed of \$1,575 million on the Oil Import Compensation Program and \$812 million in oil and gas equalization. It therefore receives a net *subsidy* of \$2,387 – \$666 = \$1,721 million, or about \$202 per capita.

Western Canada is assumed to benefit by the \$600 million in resource incentives, as well as \$126 million in oil and gas equalization. Its net *contribution* is therefore \$1,425 – \$726 = \$699 million, or \$107 per capita. This contribution to energy related redistribution would be reduced if larger, more realistic values had been assumed for the special tax incentives to the resource sector.

(\$ per capita)	West	Ontario	East
"Benefit"	110	0	280
"Contribution"	217	120	78
Net	–107	–120	202

Ontario's contribution of \$1,022 million works out to \$120 per capita. Despite its resource wealth, the West, on a per capita basis, contributes less than Ontario to the federal government's energy related redistribution programs. Of course, the producing provinces provide an implicit subsidy to Ontario and, to a lesser extent, Quebec in that consumers in these provinces are able to purchase oil and gas at a price which is low by international standards. It is impossible to establish a value on this subsidy in the absence of agreement on what the long run relationship should be between the domestic price and the world price. In any case, as oil and gas prices rise, this subsidy contracts and the drain in purchasing power from Ontario and Quebec increases.



THE ENERGY ACCOUNT

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Federal-Provincial Fiscal Reforms

Introduction

At their historic meeting in December 1976, the First Ministers laid the foundation for the "Federal-Provincial Fiscal Arrangements and Established Programs Financing Act" that was recently passed by the Parliament of Canada. This Act sets out the basic intergovernmental arrangements that will exist for at least the next five years, and as such, testifies to the fact that considerable progress has been made in terms of rationalizing the financial structure of Confederation. Among other things, it incorporates a compromise on the problem of the Revenue Guarantee, provides for an improved equalization formula, and spells out new arrangements which replace the shared-cost programs in the fields of health and post-secondary education. All told, the legislation affects over $12 billion in combined federal and provincial spending.

It is the purpose of this paper to describe the changes that have been brought about. Section I reviews the steps leading to the adoption of the new arrangements, concentrating on the issue of the shared-cost programs. Section II goes on to describe the new arrangements that were agreed upon in December, and Section III explains the mechanics of the resulting tax transfer, showing what it means for Provincial tax rates and representative taxpayers. The paper concludes with a technical appendix detailing the method by which federal contributions to the provinces will be determined commencing April 1, 1977.

I The Process of Reform

The three "established programs" at the centre of discussion in 1976 were Hospital Insurance, Medicare, and Post-Secondary Education.[1] This section reviews the structure of the old arrangements, the problems that were perceived to exist with them, and the steps leading to the new arrangements.

The Established Programs

Under the British North America Act, the provinces have exclusive constitutional jurisdiction over the fields of health and education. During

[1] Federal contributions to the provinces were authorized under the Hospital Insurance and Diagnostic Services Act (1958), the Medical Care Act (1968), and the Federal-Provincial Fiscal Arrangements Act (1967, 1972).

the 'fifties and 'sixties, however, the federal government moved into these areas, at its own initiative, for reasons of "overriding national importance". With regard to health care, the overriding consideration was the perceived need to develop a public system of hospital and medical insurance, providing all Canadians with a "national standard of service". With regard to post-secondary education, it was the perceived need to push supply beyond the point that the provinces could themselves afford. The vehicle chosen for federal involvement was cost sharing rather than increased tax abatements to the provinces.[2] By 1976-77, federal contributions to the three shared-cost programs in question totalled nearly $5.3 billion, or 12.5 per cent of federal budgetary expenditures. An overview is provided in Table 1.

Federal Contributions to Established Programs in 1976-77 — Table 1

	HIDS	PSE	Medicare	Total	Per Capita
		($ million)			($)
Newfoundland	63.2	31.3	23.1	117.6	211
Prince Edward Island	12.0	6.9	5.0	23.9	199
Nova Scotia	95.4	57.5	34.6	187.5	225
New Brunswick	77.6	38.9	28.6	145.1	211
Quebec	729.5	602.0	259.6	1,591.1	255
Ontario	987.0	618.3	346.7	1,952.0	234
Manitoba	122.6	64.2	42.7	229.5	223
Saskatchewan	105.0	57.0	38.9	200.9	215
Alberta	210.5	137.6	75.9	424.0	232
British Columbia	288.7	145.4	103.6	537.7	216
All Provinces	2,691.5	1,759.1	958.8	5,409.3	234

Source: Department of Finance, Government of Canada, November, 1976.

Each program had its own sharing formula. Under the Hospital Insurance Agreements, provinces recovered 25% of their own per capita cost on an approved range of services, plus 25% of the national average per capita cost. Under Medicare, they received a straight 50% of the national average per capita cost. Under the post-secondary arrangements, seven provinces received 50% of their actuals costs while Newfoundland, P.E.I. and New Brunswick recovered somewhat more by virtue of being on a more generous per capita formula.[3] The particular formulas notwithstanding, it is fairly accurate to say that, *overall*, the federal government paid 50% of the provinces' approved operating

[2]Although increased tax abatements were provided in the early 1960s, this approach to redressing the fiscal imbalance between the federal and provincial governments was soon abandoned in favour of expensive new shared-cost programs and enriched equalization grants. See, "Statement of the Hon. Mitchell Sharp to the Federal-Provincial Tax Structure Committee", Sept. 14-15, 1966.

[3]In 1967, these three provinces opted for $15 per capita, cumulatively escalated by the national average rate of increase of post-secondary education spending.

expenditures (at least prior to the ceilings that came into force in the middle 'seventies).[4]

The federal contributions in respect of Hospital Insurance were paid in cash to all provinces except Quebec, which received most of its payment in the form of an additional income tax abatement under the Established Programs (Interim Arrangements) Act.[5] Federal contributions towards Medicare were paid in cash to all provinces. Contributions in respect of post-secondary education were paid in the form of a tax transfer consisting of 4 points of personal income tax (converted in 1972 to 4.357 points of reformed tax) and one point of corporate income tax, plus a cash adjustment payment to bridge the difference between the value of the tax room and the full entitlement. The Quebec and post-secondary arrangements were, in a broad sense, precursors of the new arrangements insofar as they incorporated the idea of a tax-cash split.

Problems and Objectives

The problems with the shared-cost funding mechanism have been extensively examined.

From Ottawa's point of view, there were two major concerns. The first was that the federal government had no effective control over its payouts; it assumed responsibility for 50% of whatever the provinces chose to spend on the approved services. This was a legitimate concern, especially in view of the inflationary problems that beset the international and Canadian economies during the 1970s. In 1974-75, federal contributions to the three programs in question were 17.9 per cent higher than they were in the preceding year, and in 1975-76 they were 18.2 per cent higher than in 1974-75.[6]

The other problem, as seen by the federal government, was that its contributions on a per capita basis were quite different from province to province. The degree of the disparity is revealed in Table 1. This situation arose because certain provinces did not, or could not, spend as

[4]One peculiarity of the HIDS and Medicare formulas was the existence of "implicit equalization". Provinces that were spending above the national average rate per capita, like Ontario, recovered less than 50% of their actual costs, while those that were spending below recovered more than 50%. The three provinces on the per capita formula for post-secondary education were also "implicitly equalized". The term refers to the fact that, under the sharing formulas, certain provinces received differential assistance over and above their explicit equalization payments (which presumably *already* lifted them to a national average fiscal capacity position).

[5]For the period 1972-77, Quebec's HIDS tax abatement was set at 16 unequalized points of federal tax in the province. Quebec still had to file expenditure data, and a cash adjustment was made to ensure that the value of its abatement was neither more nor less than its entitlement.

[6]The 15% growth ceiling on federal contributions to post-secondary education, imposed in 1972, was already constraining these percentages somewhat. The numbers of course reflect the fact that the provinces were also experiencing similar and often unforeseen spending pressures.

much as others on their own account. Disregarding the fact that demand and cost pressures differ from province to province, the federal government took the view that differential per capita contributions were inherently inequitable, and the "levelling" of contributions became, after restraint, its second basic objective.

The provinces' views on the shared-cost arrangement varied considerably. At one end of the spectrum were Ontario, Quebec, and perhaps Alberta. While recognizing the past achievements of cost sharing, Ontario argued that there were serious drawbacks to continuing federal assistance in this form. Ontario's objections could be summarized as follows[7]:

- *Cost sharing causes distortions in provincial priorities.*
  Provinces are tempted to spend in the high cost-shareable forms of service when in fact they should be spending on lower cost but non-shareable alternatives. (This was a particularly serious concern in the area of health care, since about 20 per cent of provincial expenditures on health were not eligible for federal reimbursement).
- *Cost sharing involves too much bureaucracy.*
  Provincial expenditure data has to be compiled in a detailed and specified manner and then checked and approved by federal auditors.
- *There are undue delays in the settlement of accounts.*
  Some provinces have experienced as much as a seven-year delay in the finalization of their post-secondary education claims.
- *Cost sharing causes administrative distortions.*
  The sharing legislation often requires that a particular service be delivered by a particular provincial ministry, when in fact the province would, for its own reasons, prefer it to be delivered by some other ministry.
- *Unilateral changes or withdrawals of federal sharing leave the provinces with an unfair and unexpected burden.*

At the other end of the provincial spectrum were the Atlantic Provinces and Saskatchewan. They recognized that there were indeed problems to resolve, but feared that any departure from 50-50 cost sharing would saddle the provinces with an unfair share of financial risks, and, in addition, lead to a deterioration in national standards of service.

These, then, were the starting points: the federal government's desire to constrain its contributions and level them on a per capita basis, and the provinces' desire to achieve more streamlined arrangements, while at the same time preserving national standards and an "adequate" level of support.

[7]For a discussion of these problems see, Hon. W. Darcy McKeough, *Supplementary Papers on Federal-Provincial Finance* (Toronto: Ministry of Treasury, Economics and Intergovernmental Affairs, 1972); and, Hon. W. Darcy McKeough, *Supplementary Actions to the 1975 Ontario Budget* (Toronto: Ministry of Treasury, Economics and Intergovernmental Affairs, 1975).

The Course of the Negotiations

The move to new financial arrangements began in 1970 when the federal government first indicated its concern over escalating contributions and suggested that it would like to restrict the growth of its contributions to the rate of growth of GNP. In the following years, various federal proposals incorporating a lagged GNP escalator were discussed, only to be rejected by the provinces as too risky and financially inadequate.[8] Opting out proposals advanced by Quebec and Ontario were, in turn, dismissed by the federal government. In an attempt to break out of this continuing deadlock, a working committee was established in early 1975 and charged with developing health care cost-saving "targets" as the basis for renewed negotiations. This exercise came to an abrupt conclusion, however, when the federal government brought down its Budget of June 25, 1975, introducing arbitrary ceilings on the growth of its Medicare contributions and serving notice of its intent to terminate the Hospital Insurance Agreements in 1980 (the earliest date possible).

In the meantime, the provinces were becoming increasingly concerned about the future of the Revenue Guarantee. This program had been introduced in 1972 to protect the provinces from the revenue losses stemming from tax reform.[9] Although the Guarantee was scheduled to expire on December 31, 1976, the provinces argued that termination would force them into substantial tax increases, thereby making them the long-run losers under the 1972 reform. They suggested, therefore, that an extension of the program, or an unconditional transfer of tax room, was required. Adding to the emotion surrounding this complicated issue was the fact that, in early 1976, the federal government unilaterally changed the formula under which Guarantee entitlements were calculated; this action deprived the provinces of over $500 million in entitlements for 1976 alone.

A further area of concern was the threat of a permanent federal ceiling on the revenue equalization program, which in 1976-77 transferred $2.2 billion to the less wealthy provinces. An arbitrary feature had already slipped into this program because of unusual revenue developments in oil and natural gas. Various reforms were clearly required before the program could be renewed on April 1, 1977.

It was against this background of shared-cost ceilings and Revenue Guarantee retrenchment that the federal government chose to take a new

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[8]Early federal health proposals culminated in the Lalonde-Turner formula, presented to the provinces in May 1973; it was formally rejected by the provinces, after careful evaluation, in the fall of 1974. The Faulkner formula for replacing the post-secondary arrangements was also presented to the provinces in May 1973, only to be rejected immediately.

[9]The consequences of the 1972 tax reform for federal and Ontario revenue are discussed in Ontario Tax Study 13, *The Equity and Revenue Effects in Ontario of Personal Income Tax Reform: 1972-1975* (Toronto: Ministry of Treasury, Economics and Intergovernmental Affairs, 1977).

initiative in respect of the shared-cost programs. At the Conference of First Ministers in June 1976, the Prime Minister indicated the five principles that would underlie a forthcoming federal proposal.[10]

- The federal government should continue to pay a substantial share of program costs;
- Federal payments should be calculated independently of provincial program expenditures;
- There should be greater equality, in per capita terms, in the federal contributions to the provinces;
- The arrangements for the mature programs should be placed on a more permanent footing; and,
- There should be provision for continuing federal participation in the development of policies of "national significance" in health and post-secondary education.

These principles were fairly broad and, in that sense, could be endorsed by most Premiers.

The principles were subsequently translated into the "Established Programs Financing Proposal" that was presented to the provinces at the Meeting of Ministers of Finance on July 6, 1976. In many respects, this EPF proposal was a logical extension of previous federal offers—the principle of GNP escalation was retained, per capita levelling was retained, and the package continued to consist of tax room plus cash (though the federal government left open the particular mix that was available). Two important departures, however, were the inclusion of post-secondary education contributions into the base, and the allowance of *independent* growth streams for the tax and cash components.[11] Also, the lag in the escalator and the time frame for levelling were modified. No mention was made of a Revenue Guarantee settlement.

In the following months, the provinces met to analyze this proposal, as well as alternatives suggested by a number of provinces.[12] It was subsequently agreed that the provinces would hold out for a transfer of 4 personal income tax points for the Revenue Guarantee, and that they would pursue an EPF agreement in which: half the package would be in tax room; the new tax room would consist of only personal income tax; the tax room would be equalized to the top-province yield; and upward levelling would take place in the first year. Considerable

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[10] The Rt. Hon. Pierre Elliott Trudeau, "Established Programs Financing: A Proposal Regarding the Major Shared-Cost Programs in the Fields of Health and Post-Secondary Education", statement tabled at the Federal-Provincial Conference of First Ministers, June 14-15, 1976.

[11] Under the Lalonde-Turner proposal, the tax room was only a *mechanism* for delivering the GNP-determined quantum, so that the cash component would shrink if taxes grew rapidly (as under the PSE arrangement).

[12] Counter proposals were made by Quebec, Ontario, Saskatchewan and New Brunswick. For the Ontario proposal see, Hon. W. Darcy McKeough, *Reforming Fiscal Arrangements and Cost Sharing in Canada* (Toronto: Ministry of Treasury, Economics and Intergovernmental Affairs, 1976).

accommodations were made in reaching this first-ever consensus on financial arrangements, particularly by the Atlantic Provinces and Saskatchewan, who gave up their long-standing preference for continuing with some kind of cost sharing. The provincial proposal was relayed to the federal government by the Treasurer of Alberta, speaking on behalf of all provinces.[13]

The Meeting of Ministers of Finance on December 6 failed to find a compromise between the federal and consensus proposals, thus effectively passing the matter to the First Ministers for resolution. On December 14, the federal government suggested a number of changes and enrichments to its proposal. To this revised federal offer, the provinces reluctantly agreed, thus setting the stage for the Federal-Provincial Fiscal Arrangements and Established Programs Financing Act of 1977.

II The New Arrangements

Under the new arrangements, the federal government will transfer to the provinces 13.5 points of personal income tax and one point of corporate income tax plus the approximate value of these points in a cash payment.[14] (The tax point transfer incorporates the 4.357 PIT and 1 CIT points that the provinces already have for post-secondary education; the *new* tax room provided, therefore, is 9.143 points of PIT). The tax points are equalized to the national average yield and the cash payments escalate in line with GNP experience. In addition, the federal government will pay, starting in 1977-78, $20 cash per capita in respect of such health-related services as nursing home intermediate care, lower level residential care for adults, the health aspects of home care, and those aspects of ambulatory health services not previously covered under the Hospital Insurance Agreements. This $20 per capita will grow in the same fashion as the other cash payments.

Despite the various provincial attempts to integrate equalization with the discussions on the shared-cost programs and the Revenue Guarantee, it remains separate from the EPF. The number of revenue bases used in the determination of "fiscal capacity" has been expanded to 29 to make the system more representative and to reduce the scope for provinces to influence their own entitlements. The old ceiling on oil and gas revenues has also been revised; henceforth, 50 per cent of all non-renewable natural resource revenues will be subject to equalization,

[13]See Hon. M. Leitch, "Federal-Provincial Financial Arrangements: The Provincial Proposal", statement on behalf of all Provincial Ministers of Finance and Provincial Treasurers, December 6-7, 1976.

[14]The new package incorporates, as partial compensation for the Revenue Guarantee, 1 point of PIT as a tax transfer and the cash value of 1 PIT point in 1976-77 equalized at the national average. The Guarantee settlement was made contingent upon provinces agreeing to terminate their Hospital Insurance Agreements on March 31, 1977 rather than July 15, 1980. By accepting this, the provinces gave up the possibility of collecting the difference between the relatively more generous HIDS stream and the replacement EPF stream.

with the further stipulation that equalization in respect of natural resource revenues should not exceed one-third of total equalization.

The EPF itself is extremely difficult to evaluate in financial terms because of the many complexities and trade-offs involved. At the time of the December Conference, Ontario estimated that the federal government would contribute to all provinces $6.7 billion in 1977-78, whereas it would have contributed $7.1 billion under the Provincial Consensus Proposal. In this sense, the provinces would receive some $400 million less than they wanted in the first year. On the other hand, by extracting a compromise on the Revenue Guarantee, the provinces were successful in getting a better deal than the $6.1 billion that was on the table in June.

The situation with regard to Ontario is portrayed in Table 2. The table shows that, had the new arrangements applied to 1976-77, including the compromise on the Revenue Guarantee, Ontario would have lost almost $150 million. This loss would grow rather rapidly, because of the fast escalation of the full Revenue Guarantee compared to the partial compensation upon its termination. For 1977-78, therefore, the total loss to Ontario could well exceed $200 million.

Financial Implications of the New Fiscal Arrangements for Ontario, 1976-77 — Table 2

($ million)

Under Old Arrangements		Under New Arrangements	
HIDS	1,025	13.5 pts. of PIT	991
PSE	592	1 pt. of CIT	70
Medicare	345	Cash Transfer	1,067
Revenue Guarantee	341	Revenue Guarantee	Nil
CAP and Nursing Home Benefits Agreement	120	$20 per capita	149
	2,423		2,277

More important than the numbers are the objectives that have been achieved. For its part, the federal government succeeded in constraining the growth of its program contributions to near-GNP, and will also be making equal per capita cash payments within five years. And, as an important psychological side effect in terms of the battle against inflation, it managed to reduce its 1977 expenditure growth rate by converting sizeable federal expenditures into revenue transfers to the provinces. The provinces gain the increased flexibility that they sought by having the federal contributions detached from provincial spending patterns. The growth of the overall federal contribution leaves them with considerable risk, but they can now adjust their delivery systems, without financial penalty, in order to provide lower cost services. A legislated commitment to national standards is retained, and, on the basis of federal figures, one can expect service level differences between

the richer and poorer provinces to decline.[15] The taxpayer position remains neutral and will, hopefully, improve over the longer term because of the improved cost-effectiveness of rationalized delivery systems.

One area of the EPF story remains. It was decided that, for the convenience of the taxpayers, the *new* 9.143 personal income tax points that were to be transferred should be transferred effective January 1, 1977, the start of the taxation year. But for the first three months of 1977, the provinces would continue to receive federal contributions under the old cost-sharing arrangements. Arguing from an accrual concept, the federal government maintained that the provinces were being overpaid by three months worth of tax, and that this sum would have to be recovered. Ontario and several other provinces replied that the new tax points would not actually flow to the provinces until March, so that, from a cash-on-hand viewpoint, the provinces would be overpaid by only one month. Moreover, it was noted that there was no overlap in respect of the points the provinces already had for post-secondary education, or in respect of the point that they received as compensation for the Revenue Guarantee. The amount of money involved in this issue was substantial. But, reflecting the spirit of compromise that had made the EPF possible, the federal and provincial governments agreed to split the difference, a rather complicated recovery formula being included in the Act for this purpose.

The Established Programs Financing Arrangements that have been described in this section took effect on April 1, 1977, and will continue until at least March 31, 1982. They stand as proof that substantial progress can indeed be made in terms of streamlining the relationships between the federal and provincial governments. The federal government achieved its basic objectives, while the provinces achieved the flexibility that they sought. In the process, the accountability of government has been enhanced, for the government that is doing the spending is now more responsible for raising the revenue to finance it. There is great scope for further disentanglement of responsibility in the Canadian Confederation. The success of the 1976 negotiations suggests that a satisfactory resolution can be reached through hard work, constructive criticism, and a willingness to compromise.

III The Implications of the Tax Transfer

This section explains how the tax transfer works and how it will be implemented in Ontario. It also looks at certain structural changes to the income tax system that are required to smooth the transfer of the

[15]The figures show that the Atlantic Provinces, Manitoba, and Saskatchewan all receive a larger percentage "financial difference" than Ontario. While Ontario still disputes the existence of gains on the three programs, due to underestimation of projected provincial spending, the distributional pattern of the alleged gains is significant.

tax room. Finally, the impact of the transfer on individual taxpayers is examined, since the tax transfer is intended to leave the taxpayer without any increase in combined federal and provincial tax.

Mechanics of the Tax Transfer

Under the Tax Collection Agreements, the base on which the provinces levy their personal income tax is the federal tax itself.[16] This base was known as 100 units or "points" of tax. Under the tax transfer, the federal government reduced its tax by 9.143 points, leaving the provinces to take up this vacated tax room by raising their rates.

This reduction in the provincial tax base has implications for the provincial rates, whether or not the vacated tax room is taken up. With a smaller tax base, the provinces need to raise their rates simply to maintain their old level of revenues. Since the old 100 point base was 110.063 per cent of the new base of 90.857 points, the revenue restoration factor for grossing up provincial rates is 1.10063. For example, Ontario would need to levy a rate of 30.5% (its pre-transfer rate) × 1.10063, or 33.57% against the new federal tax *just to maintain the level of revenue that would have been generated by the pre-transfer system.*

Similarly, it is necessary to gross-up the 9.143 points transferred to the provinces by the same factor of 1.10063 to reflect the fact that these points too are applied against a discounted tax base. This converts the 9.143 points vacated by the federal government to an equivalent provincial rate of 10.06%. Looking at Ontario again, the new Provincial tax rate becomes 33.57% + 10.06% for a total of 43.63%.

Table 3 presents in more detail the calculations required to arrive at this new Provincial tax rate. Table 4 shows the same calculation from the perspective of an individual taxpayer.

Under the terms of their Tax Collection Agreements, the provinces are required to round their tax rates to a half or full percentage point. Ontario has chosen to round up from an equivalent rate of 43.63% to an actual rate of 44% of federal tax. The equivalent rates for all the provinces that result from the tax transfer as well as the actual rates announced for 1977 are shown in Table 5.

Related Tax Structure Adjustments

Efficient and effective implementation of the tax transfer necessitates adjustments to certain features of the income tax structure. These adjustments include the rounding of the new federal marginal rates, a change to the dividend tax credit calculation, and a revised federal

[16]Except Quebec which does not have a tax collection agreement but levies a separate income tax directly on taxable income.

Determination of New Ontario Income Tax Rate

Table 3

Present Situation: federal tax (base for Ontario tax) 100.00

Ontario tax rate 30.5%

Step 1: Tax point transfer reduces base to which Ontario tax applies.

present base	100.000
point transfer	−9.143
new base	90.857

Step 2: Ontario has to gross up its present 30.5% rate to compensate for base reduction.

revenue restoration factor: $\frac{100.000}{90.857} = 1.10063$

converted present rate: $30.5\% \times 1.10063 = 33.569\%$

Step 3: New tax occupancy is also grossed up to compensate for base reduction.

$9.143\% \times 1.10063 = 10.063\%$

Result:

converted present rate	33.569%
new tax room	10.063%
new Provincial rate	43.632%

Illustration of the Tax Point Transfer from a Taxpayer's Perspective

Table 4

Example: Consider the case of a taxpayer who pays $1,000 of federal income tax under the old system.

	Pre-Transfer	*Post-Transfer*
Federal Tax	$1,000	$ 908.57
Ontario Tax	$ 305	$ 396.43
Total Tax	$1,305	$1,305.00

Ontario Tax Rate:	Ontario Tax Rate:
$\frac{305}{1,000} = 30.5\%$	$\frac{396.43}{908.57} = 43.63\%$

Provincial Income Tax Rates

Table 5

(per cent)

	1976	Equivalent 1977	Actual 1977
Newfoundland	42.0	56.289	*
Prince Edward Island	36.0	49.686	50.0
Nova Scotia	38.5	52.437	52.5
New Brunswick	41.5	55.739	55.5
Quebec	n.a.	n.a.	n.a.
Ontario	30.5	43.632	44.0
Manitoba	42.5	56.840	*
Saskatchewan	40.0	54.088	58.5
Alberta	26.0	38.680	38.5
British Columbia	32.5	45.834	46.0

n.a. = not applicable.
*rate to be announced.

tax reduction scheme. Obviously, tax implications arise from these adjustments.

In implementing the 9.143 point tax transfer, the federal government did not scale down its marginal rate schedule uniformly by 9.143 per cent. Rather, it rounded to the nearest full percentage point for the sake of taxpayer convenience. The two exceptions are that the lowest marginal rate has been maintained at 6% despite the transfer, and that the 39% rate has been rounded to 36% rather than 35%. The old federal rate schedule and the adjusted federal rate schedule are shown in Table 6.

Federal Tax Rates — Table 6

Taxable Income	Pre-Transfer Rate	Pre-Transfer Rate Reduced by 9.143 Per Cent	Rounded Post-Transfer Rate
($)	(%)	(%)	(%)
0- 710	6	5.45	6
710- 1,419	18	16.35	16
1,419- 2,838	19	17.26	17
2,838- 4,257	20	18.17	18
4,257- 7,095	21	19.07	19
7,095- 9,933	23	20.89	21
9,933-12,771	25	22.71	23
12,771-15,609	27	24.53	25
15,609-19,866	31	28.16	28
19,866-34,056	35	31.79	32
34,056-55,341	39	35.43	36
55,341-85,140	43	39.06	39
85,140+	47	42.70	43

An adjustment is also required with respect to the dividend tax credit. Under the pre-transfer tax system, the dividend tax credit was defined as 80 per cent of the "gross-up" in dividends included in income for tax purposes. With the tax point transfer, maintaining this credit level would imply a larger credit for the same amount of dividend income compared to the current system. Consequently, the credit is reduced to 75 per cent of the gross-up, which is slightly more generous than that required to balance the tax transfer impact. Table 7 compares the dividend tax credit before and after the tax transfer.

A final adjustment occurs with respect to the tax reduction schemes. Both the federal and Ontario governments operate schemes which reduce tax payable. Under the pre-transfer system, the federal reduction was 8 per cent of federal tax payable, with a minimum reduction of $200 and a maximum reduction of $500.

Consistent with the federal decrease in basic tax of 9.143 per cent under the tax point transfer, one might expect that the reduction limits should be scaled down by the same percentage to a minimum

of $181.75 and a maximum of $454.28. But the tax reduction scheme needs amending rather than scaling down. This is necessary because part of the vacated tax room into which the Province is moving was sheltered from federal tax under the pre-transfer system by the federal tax reduction scheme. Since this part of the vacated tax room would no longer be sheltered after the transfer if the limits were reduced, it would mean higher total tax payable for taxpayers. To shelter taxfilers as effectively under the new system as under the pre-transfer system, the $200 minimum and $500 maximum have to be maintained and the reduction has to be raised to 8.8 per cent. Again, for simplicity, this reduction is rounded to 9 per cent, with the minimum and maximum maintained at $200 and $500, respectively.

To complement the federal alterations to the tax reduction scheme and ensure that no filers pay Ontario income tax where no federal income tax is paid, the Ontario tax reduction scheme will be enriched to include all filers with up to $1,680 in taxable income (up to $200 in federal tax payable). Under the pre-transfer system, Ontario's tax reduction scheme applied to all filers with up to $1,580 in taxable income. Ontario's complementary action, therefore, will save up to $88 in Ontario tax payable for filers with taxable income between $1,580 and $1,680.

Impact of Tax Transfer on the Dividend Tax Credit — Table 7

(dollars)

Example:

Consider the case of a taxpayer with $750 in dividends from Canadian corporations. This figure is then grossed up by one-third (=$250) to yield taxable dividends of $1,000.

	Pre-Transfer	Post-Transfer
Taxable Dividends	1,000.00	1,000.00
Federal Dividend Tax Credit	200.00	187.50
Ontario Dividend Tax Credit	61.00	82.50
Total Dividend Tax Credit	261.00	270.00

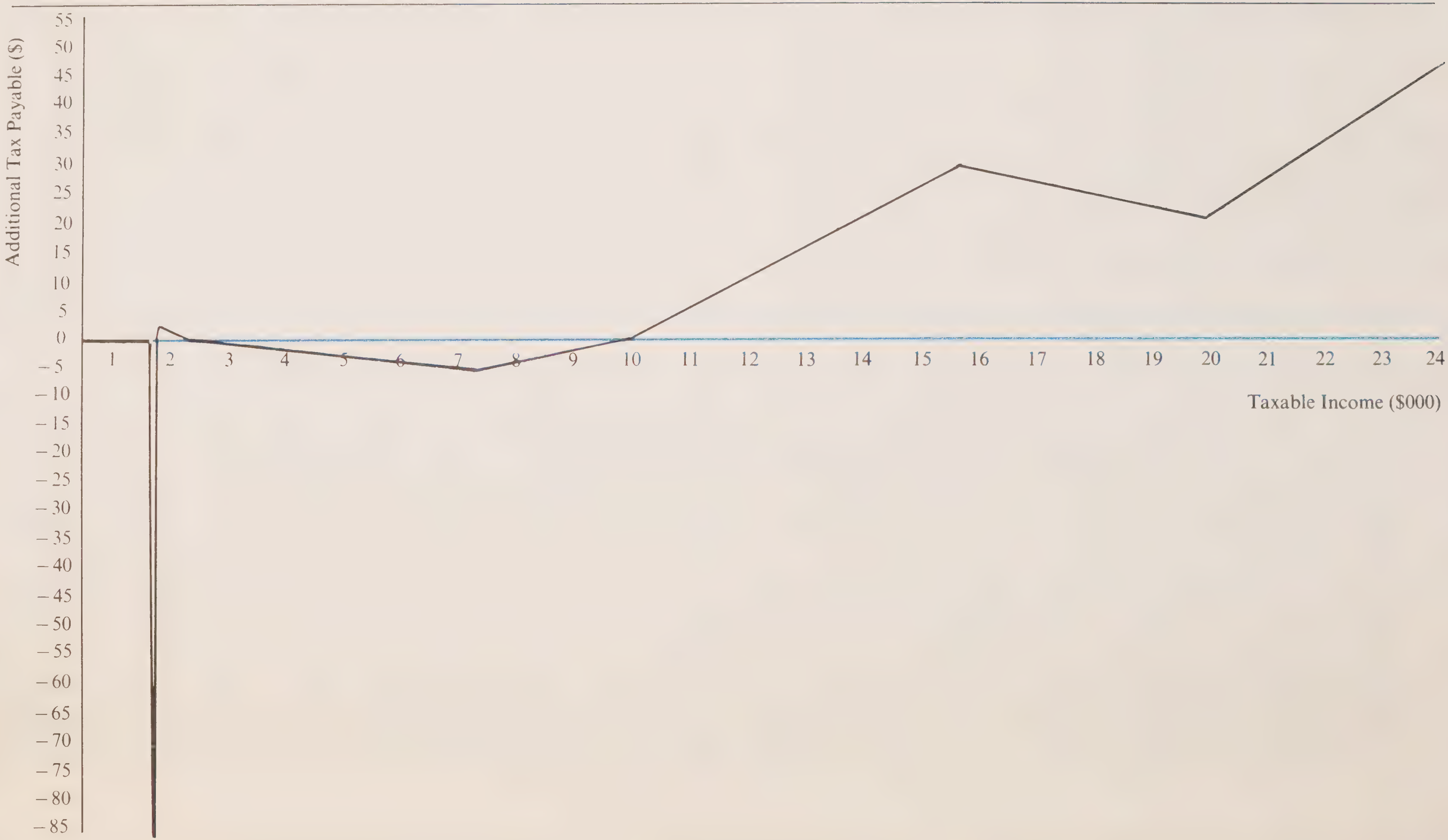
Note: The impact of the transfer on the dividend tax credit is a benefit to the taxpayer of $9 per $1,000 of taxable dividends.

Impact on Taxpayers

The clear intent of the tax point transfer contained in the new fiscal arrangements was that the impact on taxpayers should be as neutral as possible. More of taxpayers' tax dollars would go to the provinces and less would go to the federal government, but the total

Impact of Tax Transfer on Tax Payable

Chart 1



tax burden would remain the same. The transfer achieved this goal, except for slight variations in the magnitude of actual tax payable because of the rounding of tax rates and the changes to the tax reduction schemes and to the dividend tax credit. Chart 1 illustrates the size of the variations involved for the majority of taxpayers.

A general review of the actual impact of the tax point transfer on filers indicates the following features.

- Taxfilers with taxable income below $1,580 will continue to pay no federal or Ontario income tax.
- In addition, taxpayers with taxable income between $1,580 and $1,680 will now pay no tax at all (tax saving of up to $86).
- Taxpayers with taxable income between $1,680 and $2,305 will pay slightly more total tax after the tax point transfer—but in no case exceeding $2.
- Taxpayers with taxable income between $2,305 and $9,815 will pay slightly less total tax after the tax point transfer.
- Taxpayers with taxable income over $9,815 will pay more total tax. The additional tax payable for higher income taxpayers generally increases as income increases, which in turn improves the progressivity of the income tax.

Table 8 indicates the impact of the tax transfer on representative taxpayers. This table shows the very minor effect for low-income taxpayers and the modest increases for all higher income taxpayers. Even for taxpayers with $25,000 income, the maximum increase is less than one-half of one per cent of total tax payable.

Impact of the Tax Point Transfer on Representative Taxpayers

Table 8

(dollars)

Gross Income	Pre-Transfer Federal Tax	Pre-Transfer Ontario Tax	Pre-Transfer Total Tax	Post-Transfer Federal Tax	Post-Transfer Ontario Tax	Post-Transfer Total Tax	Change in Total Tax
Single Taxpayer							
5,000	143.32	104.71	248.03	111.07	136.87	247.95	−0.08
8,000	728.79	283.28	1,012.07	638.29	368.85	1,007.13	−4.94
10,000	1,139.27	408.48	1,547.75	1,009.60	532.22	1,541.82	−5.93
15,000	2,325.81	771.06	3,096.86	2,092.61	1,011.81	3,104.41	7.55
20,000	3,613.71	1,198.02	4,811.73	3,260.98	1,576.74	4,837.72	25.99
25,000	5,124.33	1,698.83	6,823.15	4,618.42	2,233.08	6,851.50	28.35
Married Taxpayer							
5,000	0.00	0.00	0.00	0.00	0.00	0.00	0.00
8,000	320.84	158.85	479.70	269.76	206.69	476.45	−3.25
10,000	719.68	280.50	1,000.18	630.04	365.22	995.26	−4.92
15,000	1,830.55	619.32	2,449.87	1,641.87	810.42	2,452.29	2.42
20,000	3,062.66	1,015.34	4,077.99	2,766.45	1,337.62	4,104.07	26.08
25,000	4,483.55	1,486.39	5,969.94	4,038.93	1,952.89	5,991.82	21.88
Married Taxpayer With Two Children							
5,000	0.00	0.00	0.00	0.00	0.00	0.00	0.00
8,000	156.60	108.76	265.37	122.96	142.10	265.06	−0.31
10,000	540.88	225.97	766.85	468.28	294.04	762.32	−4.53
15,000	1,628.81	557.79	2,186.59	1,456.56	728.89	2,185.45	−1.14
20,000	2,849.03	944.52	3,793.55	2,570.80	1,243.02	3,813.82	20.27
25,000	4,226.89	1,401.30	5,628.19	3,808.80	1,841.62	5,650.42	22.23
Single Pensioner							
5,000	0.00	0.00	0.00	0.00	0.00	0.00	0.00
8,000	314.40	156.89	471.29	263.96	204.14	468.10	−3.19
10,000	724.13	281.86	1,005.99	634.07	366.99	1,001.06	−4.93
15,000	1,841.25	622.58	2,463.83	1,651.71	814.75	2,466.46	2.63
20,000	3,073.29	1,018.86	4,092.15	2,776.18	1,342.33	4,118.51	26.36
25,000	4,497.33	1,490.96	5,988.29	4,051.39	1,958.92	6,010.31	22.02
Married Pensioner							
5,000	0.00	0.00	0.00	0.00	0.00	0.00	0.00
8,000	0.00	0.00	0.00	0.00	0.00	0.00	0.00
10,000	304.40	153.84	458.24	254.96	200.18	455.14	−3.10
15,000	1,364.95	477.31	1,842.26	1,215.65	622.89	1,838.54	−3.72
20,000	2,564.07	850.04	3,414.11	2,309.81	1,116.83	3,426.64	12.53
25,000	3,899.71	1,292.84	5,192.54	3,516.49	1,700.28	5,216.78	24.24

Appendix

Calculating EPF Entitlements

In the interest of equity, the EPF calculations necessarily became complex. As Ontario understands them, the basic calculations, including the Revenue Guarantee settlement, are as follows:

(a) For each province, determine the per capita federal contribution in 1975-76 and escalate this amount by the three-year moving average GNE index to derive values for 1976-77 and all subsequent years.

(b) Determine the 1975-76 national average federal contribution per capita, and escalate it in similar fashion for 1976-77 and all subsequent years.

(c) Translate 50% of the 1976-77 value of (b) into equalized tax points, on the basis of the yield in the two highest yielding provinces, resulting in a transfer of 8.143 *new* tax points in addition to the 4.357 PIT plus 1 CIT points that provinces already have. Add one equalized tax point for the Revenue Guarantee. Allow the tax room to grow at its natural elasticity into 1977-78 and all subsequent years.

(d) Translate the other 50% of the 1976-77 value of (b) into cash per capita. Add to this amount the cash equivalent of one 1976 equalized PIT point per capita at the national average yield. Escalate this total by the GNE index to get the basic cash entitlement for 1977-78 and all subsequent years.

(e) Since some provinces receive less under a tax-cash split than they would under an all-cash arrangement, make a transitional payment to a province if it receives less under (c) and (d) (excluding the Guarantee components) than it would have received under the all-cash entitlement of (b).

(f) Level by gradually eliminating the difference between (a) and (b). For provinces in which (b) exceeds (a), the cash contribution is raised to the national average over 3 years; for provinces in which (a) exceeds (b), the cash contribution is lowered to the national average over 5 years.

(g) Starting in 1977-78, pay to each province $20 per capita in respect of nursing home care, residential care for adults, converted mental hospitals, the health aspects of home care, and those aspects of ambulatory health services not covered under HIDS. Escalate this $20 beyond 1977-78 in the same way as other cash payments.

The following table displays the detailed calculation for Ontario and Newfoundland.

Computing EPF Entitlements[1] — Table 1

($ per capita)

	Nfld.	Ont.	Natl. Avg.
Base Contribution, 1975-76	184.80	207.70	207.60
Escalated by 1.1381, 1976-77	210.30	236.40	236.30[2]
Escalated by 1.1309, 1977-78	237.90	267.30	267.20
Equalized Tax Room[3], 1976-77	98.10	118.70	
Equalized Tax Room, 1977-78	115.40	135.30	
Basic Cash, 1976-77	118.20	118.20	
Escalated by 1.1309, 1977-78	133.60	133.60	
Tax Plus Cash, 1977-78	249.00	268.90	
Transitional Payment[4]	18.20	0.00	
	267.20	268.90[5]	
Levelling, 1977-78	−19.50[6]	+.08[7]	
Total 1977-78	247.70	268.98	

[1]Excluding Revenue Guarantee element and $20 per capita.
[2]This figure is the basis for the 50-50 split between tax and cash in the two provinces with the highest per capita tax yields.
[3]Value of 12.5 PIT points and 1 CIT point equalized at the national average.
[4]Amount necessary to bring tax plus cash up to the all-cash national average reference point of $267.20 per capita.
[5]Note that Ontario receives a "fiscal dividend" (or negative transition) of $1.70 because the value of its tax room exceeds the value of the basic cash contribution.
[6]Newfoundland is levelled up in 3 steps; in the first year subtract from the cash payments .66 × ($267.20 − $237.90) = $19.50. The actual cash per capita is thus $133.60 + $18.20 − $19.50 = $132.30. Check: $132.30 + $115.40 = $247.70.
[7]Ontario is levelled down in 5 steps; in the first year we add to the cash payments .8 × ($267.30 − $267.20) = $.08. The actual cash per capita is thus $133.60 + $.08 = $133.68. Check: $133.68 + $135.30 = $268.98.